S. HRG. 101-1057

BANKING REGULATORS' REPORT ON CAPITAL STANDARDS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

CAPITAL REQUIREMENTS AND ACCOUNTING RULES THAT DETERMINE WHAT COUNTS AS CAPITAL IN OUR BANKING SYSTEM

SEPTEMBER 10, 1990

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

36-079 WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

5241-16

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, JR., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
JOHN HEINZ, Pennsylvania
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH, JR., Delaware
NANCY LANDON KASSEBAUM, Kansas
LARRY PRESSLER, South Dakota

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
LAMAR SMITH, *Republican Staff Director and Economist*

CONTENTS

MONDAY, SEPTEMBER 10, 1990

Page

Opening statement of Chairman Riegle 1

WITNESSES

Robert L. Clarke, Comptroller of the Currency, U.S. Department of the Treasury 3
Prepared statement 7
Summary 8
The role of capital 10
Risk-based capital standards 11
The tandem leverage ratio requirement 12
Capital standards as minimums 13
Interest rate risk 14
Determining capital levels—accounting methods 15
Supervision and capital adequacy 17
Conclusion 18
Response to written questions of Senator Mack 180
William Seidman, Chairman, Federal Deposit Insurance Corporation 19
Prepared statement 22
GAAP as the reporting standard 23
Reporting differences 25
Capital differences 29
Differences in bank and thrift capital standards 33
Capital requirements for interest rate risk 36
Reliability of financial information 37
Recommendations on accounting and reporting standards 39
Improving auditing of federally insured depository institutions 40
Response to written questions of:
Senator Riegle 182
Senator Mack 197
Timothy Ryan, Director, Office of Thrift Supervision 45
Prepared statement 49
History 52
Capital 53
Accounting 55
Market value accounting 56
Interest rate risk 58
Response to written questions of Senator Mack 200
Wayne D. Angell, Member, Board of Governors, Federal Reserve System 62
Prepared statement 65
Introduction 66
The role of accounting standards 67
FIRREA mandate for uniform accounting standards 68
Market value accounting 69
The importance of capital standards 72
Differences in capital standards 75
Assessment of capital adequacy 75
Conclusion 78
Response to written questions of:
Senator Riegle 172
Senator Mack 178
Richard C. Breeden, Chairman, Securities and Exchange Commission 97

Page

Richard C. Breeden, Chairman, Securities and Exchange Commission—Continued
Prepared statement 118
I. The role of capital requirements and business expansion in the thrift crisis: accounting factors 121
II. How the thrift accounting techniques facilitated expansion without real capital and concealed true financial condition 131
III. The proper role of financial reporting: market based accounting ... 147
IV. Conclusion 156
Charts 1–7 158

BANKING REGULATORS' REPORT ON CAPITAL STANDARDS

MONDAY, SEPTEMBER 10, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m. in room SD-538 of the Dirksen Senate Office Building, the Senator Riegle (chairman of the committee) presiding.

Present: Senators Riegle, and Bond.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me particularly welcome our witnesses this morning, a very distinguished group of witnesses, and let me welcome all others in attendance.

Today is a very important hearing that will deal with the question of capital requirements and accounting rules that determine what counts as capital in our banking system, and clearly I think it should be obvious to all that capital in the end is the key to safety and soundness in the banking system. It really undergirds the system and it provides in many ways the discipline to keep the system working safely and soundly.

There are three lines of defense in keeping industry losses to a minimum, and in the worst case avoiding any eventual taxpayer bailout through Federal Deposit Insurance.

The first of course is the prudent use of depositors' funds by means of the underwriting practices carried out by loan and investment officers at banks and thrifts.

The second level of defense, if you will, in a sense is the private equity capital that the shareholders have invested in the banks and thrifts, both initial capital put in and retained earnings over the years, and that provides a second line of strength with respect to protection in capital.

The third and the last of course, and the one we hope seldom if ever to have to get to, is the Federal Deposit Insurance which is there as a matter of our national interest and having a safe and sound and stable banking structure, and in worse case situations, and we have seen clearly some of those now. Then there is a requirement to use that as our last resort in terms of a source of capital.

During the 1980's I think it's fair to say that each of these areas was weakened. Starting with the first, many lending officers were

convinced by inflationary trends that real estate values could only go up, and it appears as if there was a considerable loss of sight of fundamental economics that were beginning to build up as evidenced by vacancy rates and cash flow.

Some banks thrifts allowed their capital levels to erode. The deposit insurance fund for thrifts became insolvent and the deposit insurance funds for banks has also reached a historic low point. In fact, the FDIC, as we know recently, has taken up a recommendation to increase the deposit insurance premiums paid by banks to try to stop the erosion in the balance in the bank fund and to build it up.

We will be reviewing here in this room tomorrow the condition of the banking system and again on Wednesday when the General Accounting Office and the Congressional Budget Office will also be here to be heard from.

Correcting the problems of the past is hard work and no one knows that better than you individuals at the table because you carry so much of the burden now for dealing with the problems that we're aware of. And as more conservative lending practices are applied, some borrowers are bound to protest as they are doing, and we have talked about that, Comptroller Clarke, directly.

As deposit insurance premiums are increased some shareholders of banks and thrifts will complain about devaluing the charter and even raise the question of whether they can afford the premiums, and I'm sure, Bill Seidman, you've probably been hearing some of that commentary already.

The debate over these issues is complex and arcane, but the capital question really becomes simple in the sense of having to determine how much is enough. We faced that question for savings and loans last year, and it was one of the most contentious issues.

Today we face a similar question for banks. The issue is what will be required leverage ratio for banks. Now the Comptroller has proposed lowering the leverage ratio to 3 percent. The Federal Reserve has proposed a leverage ratio of 3 percent plus an additional amount for all but the highest rated banks. The FDIC has not issued a revised leverage ratio.

The debate on the bank leverage ratio has been going on since October 25, 1989 when all the bank regulators testified on the condition of the banking industry, and I think it's time to make an all out effort to try to resolve it.

The importance of the leverage ratio cannot really be overstated. Even though we are embarking on the new risk-based standard that may ultimately prove beneficial, I am concerned that too much reliance on an untested standard could have a profound set of unintended effects on the safety of the banking system and on our economy as a whole, and I think we're at a point where all serious discussion in this area has to have that very much not just in the background, but more in the foreground. What is the strength of the system now and how do we make adjustments without applying greater stresses and strains than prudence would dictate.

Today we will also review the accounting standards that determine the rules for what counts as capital, and I heartened to hear Director Ryan state that accounting rules should reflect economic reality.

I look forward to hearing his views as well as those of the other regulators here today.

Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 requires that the bank and thrift regulators report to Congress on capital and accounting standards.

I have also asked SEC Chairman Breeden for his views on the accounting standards, and we look forward to his appearance on a second panel here this morning.

So I want to welcome all of our witnesses today and to say that we are very glad to have them back before the committee, and I will proceed this morning in the following order.

I will call first on Robert Clarke, then on William Seidman, then on Timothy Ryan and then finally on Wayne Angell. So we will go in that order.

Comptroller Clarke, we are pleased to have you, and we would like to have you start out.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

Comptroller CLARKE. Thank you, Mr. Chairman.

As you have stated, I am here with my colleagues to report on the progress of the Federal financial institutions supervisors toward ensuring that banks and thrift institutions have adequate capital to support their operations. I am also here to discuss our actions on capital adequacy, which I believe, and you have certainly underscored, are so critical to our efforts to assure a safe and sound banking system. As you know, I have submitted a written statement that discusses both of these subjects in detail, and if that statement is incorporated in the record, which I would ask that it be, then I would like to focus in my opening statement on a couple of other important points.

The CHAIRMAN. Very good. We will make your full statement a part of the record as we will for your colleagues who are here. So I would like you very much to summarize and focus your comments where you think it's most important for us to hear from you.

Comptroller CLARKE. As you know, I testified before this committee almost a year ago on the subject of capital. At that time, I discussed how all three Federal bank regulators, along with the banking authorities in 11 other countries had adopted risk-based capital guidelines for commercial banks. These rules were based on the principle that a bank's capital requirement should reflect the riskiness of its assets. The guidelines also importantly redefined capital to require that at least one-half of a bank's regulatory capital consist of core capital, that is to say, primarily common stockholders' equity and related surpluses. In short, our adoption of those rules after years of international negotiation and debate was a significant move toward a tougher standard of capital adequacy.

Moreover, Mr. Chairman, Congress recognized the advantages of our risk-based capital approach in enacting FIRREA last December. That law called on the Office of Thrift Supervision to establish risk-based capital standards for savings and loan associations which are based upon the same principle underlying the standards of the banking agencies, even though they are different in some

technical respects from the guidelines for banks. Thus, all of the Federal agencies today have generally similar minimum capital requirements and accounting rules. Some differences remain, but except for the differences between bank and thrift capital standards that are mandated by FIRREA, most of the differences are minor.

Adequate capital forces market discipline on a bank, putting pressure on bank management to operate efficiently and decreasing the willingness and the ability of the bank to gamble with insured deposits. It also protects the institution from insolvency due to unanticipated losses, and in doing so it preserves the franchise value of the institution and prevents claims against the deposit insurance fund.

We cannot, however, always assume that the more an institution is capitalized the better its financial condition. At some level the cost of holding capital begins to outweigh its benefits. When you reach that point, if you have capital requirements that are too high, there is an incentive for some institutions to increase risk taking to cover those costs, with the result that there can be more, rather than less risk to the insurance fund. Other institutions may find it impossible to compete effectively if the costs of capital are too high.

So supervisors have to strike a balance in setting capital standards that will provide market discipline and protection from insolvency, while at the same time being attentive to the importance of the competitiveness of banks and the ability of banks to provide an acceptable return to the providers of capital. I believe that our risk-based standards strike that balance.

By the end of this year banks will be expected to have total capital equal to 7.25 percent of risk-weighted assets. When the standards are fully phased in at year-end 1992, banks will be required to have total capital equal to at least eight percent of risk-adjusted assets. Eight percent, I emphasize, is a minimum, just as the capital standards that we are phasing out are minimums. Most banks will be expected to maintain even higher capital levels, and historically most banks have operated at capital ratios far higher than the minimums that we have set in the past.

Even so, the risk based capital guidelines alone will increase significantly the total amount of capital required in the banking system and, importantly, they require the greatest increase at multinational and large regional institutions. These are the institutions that because of their size present the greatest risk to the insurance fund, and they are the institutions that have in the past produced some of the biggest losses.

But of at least equal importance is the fact that these guidelines increase the quality of capital as well as the quantity. The old standards allowed the loan loss reserve to be counted in primary capital. The new standards insist that at least one half of the capital required by the risk-based formula be pure equity capital, and of the other half only a fraction can be represented by the loan loss reserve.

My written statement discusses these issues in much more detail.

Mr. Chairman, risk-based capital standards are aimed at asset risk, the risk that the value of an asset will decline. But banks are

also exposed to other types of risk, interest rate risk or foreign exchange rate risk just to name a couple. And not surprisingly, the principal protection against these other risks is also capital.

So last year all three Federal bank regulators agreed, as you noted, that in addition to the risk-based capital guidelines, there had to be an additional backstop to the minimum level of capital that a bank must hold. That backstop we call the tandem leverage ratio. Without it, the guidelines could theoretically allow a bank to operate with no capital, for example, by investing all of its deposits in U.S. Government securities, which have a zero risk weighing. Now that, of course, is an extreme example. I would suggest that the likelihood of something like that happening is slight, but the conceptual possibility is there.

We agreed that a backstop to the risk-based capital guidelines was necessary, and we believe that that backstop should consist only of common equity capital and surplus, real capital, so to speak, capital in its most tangible form.

The tandem leverage ratio is a supplement to the risk-based guidelines because a bank would have to meet both minimums. A bank that satisfies one minimum requirement but not the other would have to raise capital or adjust its portfolio so that it meets both.

Therefore, the tandem leverage ratio cannot be viewed in isolation. Its purpose and effectiveness must be evaluated in the context of the overall system of capital regulation.

Now I want to note here for the record that the minimum leverage ratio should strike a balance between the cost and benefits of capital requirements, a balance that is inherent in all capital regulation. We believe the OCC's proposal of a 3-percent minimum leverage ratio for top-quality banks strikes that balance. It allows the risk-based standards to work while at the same time protecting the safety and soundness of the national banking system. Higher or lower minimums for the tandem ratio would result in one or the other of those goals being compromised. Specifically, a higher tandem ratio would undermine the risk-adjusted capital guidelines. In doing so it would undermine all of the work which we have devoted to achieving international capital standards that match a bank's capital requirements to the riskiness of its business.

Mr. Chairman, in closing I would like to put the capital adequacy regulation into the context of bank supervision generally. The recent crisis in the thrift industry has made even clearer the fact that to ensure a stronger and sounder banking industry we must have appropriate accounting standards, real capital, and strong supervision. Capital adequacy is a critical element in this mix, but it cannot stand alone. Capital standards are effective only if they are accompanied by the two other elements.

We have taken significant action over the last years to assure that all those elements are present. In regard to supervision, for example, the OCC has implemented a new closure rule that allows us to close an institution when its equity capital is eliminated. In the past, our policy was to close an institution when its primary capital was exhausted, and, as you will recall, primary capital included the loan loss reserve. Our new rule allows us to close an institution when its equity is exhausted, but while reserves still exist

to cover anticipated and identifiable losses, thus limiting the opportunities for excessive risk taking by bank management and, we expect, decreasing the cost of most bank failures, in some cases significantly.

Mr. Chairman, this is one of several examples of the progress that I believe we have made over the last year in assuring a safe and sound banking system in the years to come. I appreciate having the opportunity to talk to you about this progress and would be pleased to answer any questions that you or any other members of the committee may have.

Thank you.

The CHAIRMAN. Thank you very much, Comptroller Clarke, that is a very helpful summary.

[The complete prepared statement of Robert Clarke follows:]

For Release:
September 10, 1990, 10:00 a.m.

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
of the
UNITED STATES SENATE

September 10, 1990

SUMMARY OF STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY

Mr. Chairman and members of the Committee, I am here to discuss the report of the Office of the Comptroller of the Currency (OCC) comparing the capital and accounting standards of the OCC with those of the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC). As the OCC's report indicates, all of the federal banking agencies have generally similar minimum capital requirements and accounting rules. Except for the differences between bank and thrift capital standards that are required by FIRREA, most of the differences are relatively minor. Moreover, we are continuing to work with the other agencies to eliminate many of the remaining differences.

It should not be surprising that there are only minor differences in the capital standards of the federal banking supervisory agencies. All the agencies consider it essential that the institutions which they supervise maintain adequate capital. Bank supervisors have been working together since 1986 to modernize capital standards, reflecting our collective belief that capital plays a fundamental role in maintaining the safety and soundness of the banking system.

In 1989, the OCC, FRB, and FDIC adopted common risk-based capital standards for insured commercial banks based upon the International Capital Accord developed by the Basle Committee on Banking Supervision. Risk-based capital is an important improvement over current capital standards. Its improvements include: (1) redefining capital to require a greater reliance on common equity, which increases the bank's ability to absorb unanticipated losses; (2) incorporating off-balance sheet activities into the determination of capital minimums; and (3) weighing assets according to broad measures of their credit risk.

In addition, the banking agencies are at various stages of implementing new minimum ratio of capital to total assets (minimum leverage ratio) that will employ the new definition of total capital. The minimum leverage ratio ensures that even banks that invest exclusively in low risk-weighted assets still have to maintain a certain level of capital. It is based on the principle that any bank, no matter how minimal its risk, needs to maintain some level of capital to protect against unseen and extraordinary events.

Together with the other supervisors of insured depository institutions, the OCC is constantly searching for new methods to improve our measurement of capital and our determination and enforcement of capital adequacy. For example, the OCC is

participating in several efforts to improve this link between interest rate risk and capital adequacy. Domestically, we have implemented several regular training programs that are designed to enhance the ability of OCC examiners to assess the level of interest rate risk and the quality of risk management at national banks. Internationally, we are participating, along with the FRB, in a subgroup of the Basle Committee on Banking Supervision that is in the process of developing a comprehensive method for measuring an institution's interest rate risk. We have also been participating in an analysis of the advantages and disadvantages of market value accounting as part of the Department of Treasury's study of the deposit insurance system. The study will investigate the benefits of market value accounting and the costs of implementing the required recordkeeping and information systems.

Thus, all of the federal supervisors are implementing similar risk-based capital standards and supplementing these standards with leverage requirements. Equally important, all the supervisory agencies have stated that these standards are minimums and that most banks will be expected to continue to operate with capital levels well above the regulatory minimums. By linking each individual institution's capital adequacy to qualitative and quantitative measures of risk, we are establishing a system where the more risky the bank's activity, the greater its required capital level.

For Release
September 10, 1990 10:00 a.m.

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
of the
UNITED STATES SENATE
September 10, 1990

Mr. Chairman and members of the Committee, I am here to discuss the report of the Office of the Comptroller of the Currency (OCC) comparing the capital and accounting standards of the OCC with those of the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC). The OCC submitted the report on August 10, 1990 pursuant to Section 1215 of FIRREA. As the OCC's report indicates, all of the federal banking agencies have generally similar minimum capital requirements and accounting rules. Except for the differences between bank and thrift capital standards that are required by FIRREA, most of the differences are relatively minor. As to the differences that remain, we are continuing to work with the other agencies to reduce many of them.

Consequently, I will address the additional issues you raised in your invitation letter and discuss the efforts of the OCC to ensure capital adequacy at national banks.

The Role of Capital

It should not be surprising that there are only minor differences in the capital standards of the federal banking supervisory agencies. All the agencies consider it essential that the institutions which they supervise maintain adequate capital. Bank supervisors have been working together since 1986 to modernize capital standards, reflecting our collective belief that capital plays a fundamental role in maintaining the safety and soundness of the banking system. Adequate capital forces market discipline on a bank -- putting pressure on bank management to operate efficiently and compete effectively, and decreasing the willingness of the bank to gamble with insured deposits. It also protects an institution from insolvency due to unanticipated losses. This helps to preserve the franchise value of the institution, while minimizing claims against the deposit insurance fund.

Bank supervisors must maintain capital standards that will promote market discipline and provide protection from insolvency, while at the same time, being sensitive to maintain competitiveness and provide an acceptable return to investors.

Risk-Based Capital Standards

In 1989, the OCC, FRB, and FDIC adopted common risk-based minimum capital standards for insured commercial banks based upon the International Capital Accord developed by the Basle Committee on Banking Supervision. All of the G-10 countries, as well as many additional countries, have adopted the Basle framework. As a result of these standards, at the end of this year, banks will be expected to have total capital equal to at least 7.25 percent of risk-weighted assets. When risk-based capital is fully phased in, at year-end 1992, banks will be required to have total capital equal to at least 8 percent of risk-weighted assets.

As required by FIRREA, in December 1989, the OTS established risk-based capital standards for savings and loans which, while different in some respects, are based upon the same principles underlying the banking agencies' risk-based capital standards.

Risk-based capital is an important improvement over current capital standards. This is reflected in both the definitional improvements in capital requirements and in the indications of its effects. Its improvements include incorporating off-balance sheet activities into the determination of capital minimums; and weighting assets according to broad measures of their credit risk. More importantly, the new standards redefine capital to increase a bank's ability to absorb unanticipated losses. It requires that at least one-half of a bank's regulatory capital consist of core capital (primarily common shareholder's equity, non-cumulative perpetual preferred stock, and related surpluses). The remainder of a bank's capital can consist of capital elements such as subordinated debt and cumulative preferred stock which provide additional capital support. The allowance for loan and lease losses (ALLL) -- which is designed to account for anticipated losses and thus offers limited capital support -- is limited in the determination of regulatory capital to 1.25 percent of risk-weighted assets. In the past, a bank could meet minimum requirements by relying entirely upon the ALLL.

The risk-based capital guidelines will significantly increase the total capital required in the banking system and require the greatest increase at multinational and large regional institutions -- the institutions that, because of their size, present the greatest risk to the banking system and to the deposit insurance fund. Based upon March 1990 data, we estimate that:

(1) As of March, 1990, over one year after the risk-based capital requirements were finalized, 562 out of 12,414 insured commercial banks that hold 36 percent of all the assets in the banking system did not meet the requirements and, thus, still needed to make further adjustments in order to comply with the standards by final implementation on 12/31/92. By comparison, on the same date, only 457 insured commercial banks, accounting for only 3 percent of assets failed to meet the old capital minimums, which will expire on 12/31/90.

(2) If the insured commercial banks that do not meet the risk-based capital standards were to make no changes that affect risk-weightings in their portfolios, we estimate that they would need to raise an additional $24 billion in capital to meet the fully phased-in risk-based capital standards.

(3) For all banks to meet the year-end 1992 risk-based capital standards, the system would need to have $217 billion in capital. To meet current standards only $195 billion would be needed. Moreover, as explained earlier, risk-based capital relies much more heavily upon common equity than do current standards.

The Tandem Leverage Ratio Requirement

To supplement the risk-based capital standards the banking agencies are in various stages of implementing a new minimum ratio of capital to total assets (minimum leverage ratio) that will employ the new definition of total capital. This is a tandem capital requirement that is in addition to the risk-based capital requirements of the international accord. Banks will have to meet both the minimum leverage ratio and the risk-based capital requirements.

As this Committee knows, there has been a great deal of discussion about the appropriate leverage ratio requirements. The FRB has issued a final rule which sets a minimum leverage ratio for top rated banks of 3 percent of adjusted total assets. The OCC has also proposed a 3 percent minimum leverage ratio for the best managed banks. The FDIC is in the process of developing its own leverage ratio proposal. All leverage ratios would work in tandem with the risk-based capital requirements. Banks would have to meet both the leverage ratio and the risk-based capital requirement. It is also important to remember that, because of the improved definition of capital under the risk-based capital guidelines -- which increases the emphasis on pure equity capital -- a lower ratio of capital to assets does not necessarily imply a reduction in real capital levels when compared to the old definitions of capital.

The purpose of the leverage ratio is to ensure that even banks that invest exclusively in low risk-weighted assets still have to maintain a certain level of hard capital. It is based on the principle that any bank, no matter how minimal its risk, needs to maintain some level of equity capital to protect against unseen and extraordinary events.

The OCC and the other members of the Basle Committee have all agreed that the risk-based capital standard should be the primary method for determining capital adequacy. To the extent that the leverage requirement overrides risk-based capital as the relevant capital standard at an institution, it undercuts the incentives created by risk-based capital to reduce credit risk. Moreover, because the leverage requirement does not take into account off-balance sheet activities, it encourages a bank to simply move risks off the balance sheet while possibly increasing the actual risk at the institution. In fact, an institution using this strategy might be able to meet a higher leverage requirement without any increase in capital or reduction in risk -- just by exchanging on-balance sheet risks for off-balance sheet risks. The risk-based capital system was designed to help address this situation. Setting the minimum leverage ratio too high, would destroy the risk reduction incentives of a risk-based system.

In addition, if U.S. banks are required to meet too high a leverage requirement, it would hamper their ability to compete internationally. If the leverage requirement requires most banks to increase their level of Tier 1 capital above the level required by risk-based capital, then they will be at a competitive disadvantage.

Capital Standards As Minimums

All of the federal supervisors are implementing similar risk-based capital standards. Equally important, all the supervisory agencies have stated that these standards are minimums and that most banks will be expected to continue to operate with capital levels well above the regulatory minimums. The OCC and the FRB have both stressed that operating with capital ratios at regulatory minimums is acceptable only for institutions with high asset quality, diversified portfolios, and well managed on- and off-balance sheet activities.

One reason why supervisors view the risk-based capital standard as a minimum is that the standard contains only limited adjustments for other risks found in banks, including interest rate risk, foreign exchange rate risk, operational risk, and fiduciary risk. Although we have not developed explicit formulae for capital charges for these other risks, in practice, an individual institution's capital adequacy will be based upon an

examiners' quantitative and qualitative assessment of all the risks at the institution. Thus, national banks and Congress should understand that only the best managed banks will be considered adequately capitalized by the OCC if they operate with capital levels at the regulatory minimum. Compliance with regulatory minimums is only the first step in the determination of capital adequacy.

Of course, most banks recognize on their own that simply meeting minimum capital standards is not sufficient and they already maintain capital levels well above regulatory minimums. They strive to maintain protection, not only against insolvency from unanticipated losses, but against the potential for failure to comply with capital standards.

Interest Rate Risk

In your invitation letter you asked that I comment on the methods the OCC is employing to account for the other risks that banks face, particularly interest rate risk. The OCC evaluates the level of interest rate exposure and the quality of risk management as part of our supervisory process. We are taking steps to improve our own examiner training and policy guidance on interest rate risk and participating in domestic and international efforts to improve the supervision of interest rate risk at banks.

Interest rate risk is the exposure of a bank's earnings and capital to future movements of interest rates. All banks assume interest rate risk as part of their normal banking operations. We require that banks prudently manage this risk, that exposures be adequately measured, and that capital be available to support the exposure. Unlike credit risk, which can be measured asset by asset and is linked to the bank's investments, interest rate risk should be examined on a portfolio basis. The sum of the interest rate sensitivities of individual instruments does not translate into the interest rate sensitivity of a portfolio of these instruments. The values of the instruments can move in different directions when interest rates change. Therefore, an instrument that is sensitive to interest rates may actually reduce the institution's interest rate exposure by countering exposures in other investments. Therefore, it is much more complex to assess the overall interest rate risk at an institution than it is to assess the overall credit risk. While a capital requirement associated with credit risk can be determined by an assessment of the risk in individual activities, interest rate risk can only be accurately measured if the entire portfolio is simultaneously examined.

The appropriate method for measuring the level of interest rate exposure at an institution depends upon the size and

complexity of the bank. Appropriate methods range from simple, manually prepared reports of repricing imbalances to complex computer models.

Because of the wide variety of available interest rate sensitive investment and trading options, an institution's interest rate exposure can change quickly. Therefore, a periodic assessment of the level of exposure at an institution provides supervisors with only limited comfort that risks are controlled and capital protection is adequate. In addition to assessing the level of interest rate risk at an institution, it is important for the supervisor to insure that the institution's interest rate risk is prudently and comprehensively managed.

In evaluating an institution's interest rate risk management, the OCC looks to see that: (1) the bank has a clear and explicit philosophy on the assumption and management of interest rate risk; (2) the bank sets limits on the level of interest rate risk it is willing to assume; (3) the bank appropriately measures its level of exposure to future interest rate movements; and (4) the bank has procedures in place that link risk measurement and management decisions.

Based on our evaluation of the level of interest rate exposure at the institution and the management of this exposure, the OCC assesses the adequacy of the bank's capital. The OCC is participating in several efforts to improve this link between interest rate risk and capital adequacy. Domestically, we have implemented several regular training programs that are designed to enhance the ability of OCC examiners to assess the level of interest rate risk and the quality of risk management at national banks. Internationally, we are participating in a subgroup of the Basle Committee on Banking Supervision that is in the process of developing a comprehensive method for measuring an institution's interest rate risk. This measurement system will be tested in 1990 and 1991.

Determining Capital Levels - Accounting Methods

Capital requirements are not the end of the supervisory process. Three other elements are essential: (1) supervisors must insure that the accounting methods for determining the amount of capital at an institution are fair and objective; (2) supervisors must take firm action to force corrective action and limit risk taking at undercapitalized institutions; and (3) supervisors must close an institution when capital is exhausted.

Equity capital is the difference between an institution's assets and liabilities. Thus, the method by which individual assets and individual liabilities are valued and reported can significantly alter the reported equity at an institution.

Commercial bank supervisors have developed uniform reporting standards for the quarterly report of financial condition and income filed by all commercial banks and BIF-insured mutual savings banks.

Although the federal banking agencies have broad authority to establish their own rules for regulatory filings, regulatory reporting standards have substantially adhered to generally accepted accounting principals (GAAP). In a few instances, supervisory concerns have led us to implement more stringent requirements. We are constantly reviewing our reporting requirements, searching for methods to improve the accuracy of the reports of condition. In addition, the American Institute of Certified Public Accountants, along with the Financial Accounting Standards Board, is examining, and working to eliminate, the differences in bank GAAP and thrift GAAP. However, as you have recommended Mr. Chairman, we are not willing to make changes just to create consistency. Our objective is to make changes where they provide a fairer and more accurate reflection of the condition of the institution.

In recent years, GAAP and these reporting standards have come under increasing criticism. Under GAAP, many assets and liabilities are carried on the balance sheet at their historical costs, with subsequent changes in market value neither disclosed nor reflected in income or equity. The increased liquidity of some bank assets and the FDIC's increased failure resolution costs have heightened pressures for accounting based upon the market value of assets and liabilities.

In part, because many bank assets are long-lived and held to maturity, valuations have been traditionally based upon historical costs. Historical costs: (1) provide consistency across institutions and industries; (2) are relatively easy to measure; and (3) can be reasonably assumed to represent the fair value of the resource when it is acquired or expended.

This is not to say that accounting standards completely ignore changes in market values. When an institution enters into an activity with the intent of disposing of the asset before being repaid in full, bank supervisors and GAAP generally require reporting of the asset at the lower of cost or market value. This is because the institution's realization on this asset is sensitive to changing market and economic conditions. Even for assets carried at historical value, GAAP recognized changes in value due to credit losses and exposures. Identified losses must be charged-off immediately. Anticipated, but not yet identified, credit losses must be reserved for in the allowance for loan and lease losses. Thus, the net value of an asset corrects for identified and anticipated credit losses.

I can appreciate the theoretical appeal of market value accounting. However, there are practical problems in applying market value accounting to the bank's entire balance sheet. First, the computation of market value is difficult and extremely sensitive to assumptions for assets or liabilities with limited or non-existent markets. The market value of a bank's liabilities are particularly difficult to estimate. Secondly, market value accounting leads to increased volatility of earnings and equity because the entire balance sheet must be constantly readjusted to reflect changes in interest rates and market conditions. This would make it difficult for a bank to maintain capital adequacy because it would have to anticipate and correct for short-term changes in market conditions.

An analysis of the advantages and disadvantages of market value accounting is part of the Department of the Treasury's study of the deposit insurance system. The study will investigate the benefits of market value accounting and the costs of implementing the required recordkeeping and information systems. Any recommendation for increased reliance on market value accounting will be reflected in the recommendations of this study.

Supervision and Capital Adequacy

Capital standards are an important element of protecting the safety and soundness of the banking system. But, they are not all that is needed. They are effective only if they are accompanied by strong supervision. Supervisors must make certain that each institution's reported condition is accurate and that problems are recognized and managed.

Usually, undercapitalization is the result of a gradual deterioration in asset quality, excessive growth, or uncontrolled operating expenses. Therefore, we do not focus only on institutions that fall below regulatory minimums. The OCC, through its supervisory policies, will usually have recognized an institution as a problem institution before its capital level falls below regulatory minimums. This is one reason why there are over 100 more banks on our problem bank list than on the list of banks that do not meet current capital minimums.

Like the other supervisory agencies, the OCC devotes significant examiner resources to undercapitalized and other problem institutions. When an OCC examiner identifies an undercapitalized institution, the examiner works with the institution to develop and maintain a plan to correct the problems and increase capital levels. Examiners also regularly review the bank's condition, the accuracy of its supervisory reports, its compliance with supervisory orders, its management quality, and its solvency. In some cases we issue supervisory

orders -- for which failure to comply can result in severe penalties.

Of course, supervisory actions and efforts by the institution's management will not insure that the institution does not fail. Banks must compete in the market place. As in any competitive environment, some institutions will find it impossible to compete. This year the OCC implemented a new closure rule that allows us to close an institution when its equity capital is eliminated. In the past, our policy was to close an institution when its primary capital -- including the allowance for loan and lease losses -- was exhausted. This allowed institutions to continue to operate even though the shareholder's financial interest in the institution no longer had any value. The new equity insolvency rule allows us to close an institution while reserves still exist to cover anticipated and identifiable losses. This allows us to close institutions several months earlier than before the rule was adopted, limiting opportunities for excessive risk-taking by bank management. In addition, the availability of the reserve to absorb losses, together with earlier closure, should decrease the average cost of failure resolution to the insurance fund.

Conclusion

We recognize that capital adequacy together with strong supervision and timely closure are the principal lines of protection to the safety and soundness of the financial system and the protection of the insurance funds. Together with the other supervisors of insured depository institutions, the OCC is constantly searching for new methods to improve our measurement of capital and our determination and enforcement of capital adequacy. All the federal banking agencies approach capital adequacy using similar methods and have, or soon will have, similar minimum capital standards. By linking each individual institution's capital adequacy to qualitative and quantitative measures of risk, we are establishing a system where the more risky the bank's activity, the greater its required capital level.

The CHAIRMAN. Next we will hear from William Seidman of course who serves as the Chairman of the FDIC.

STATEMENT OF WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Chairman SEIDMAN. Thank you, Mr. Chairman.

I applaud your holding hearings on this subject, and particularly on the differences between the agencies with respect to capital requirements. I think we have gone far too long with those differences outstanding. I think those differences are a problem for the industry and its planning.

I think we have to come to a resolution of differences between the various regulators, and I believe that this hearing will be a very useful step in achieving that result.

I would like to note that while we have significant differences, we in fact agree on many more things than we disagree, and your amiable regulators have actually met most of the tests of coming up with common standards. However, there are standards which we have not been able to agree on, and I do not think that we can continue with those differences without causing real harm to the system.

So I would like to concentrate and talk about the same subject that Comptroller Clarke has talked about. As you know, I have covered a number of other items in my written testimony.

Banking agencies' existing uniform leverage requirements are based on a definition of primary capital plus secondary capital and, as you've heard, the agencies are revising these standards so that capital definitions will more closely track those used in the risk-based capital framework.

But as one who participated in the risk-based process at the international level, those standards were primarily designed for banking systems around the world where almost all banks are large banks and international banks.

The standards I think are useful and they can be used for smaller banks, but no one else in the world has a banking system like the United States with thousands of small banks, and I think it is a real error to try to force conformity of the American system in total with the risk-based standards. They are, as anyone who looks at them can see, very rough standards.

I mean there are weights there that have been sort of a compromise and agreed upon. I think they are good standards, but they are certainly rough estimates of risk in an institution. So we believe that the agencies in adopting new capital standards should avoid any meaningful reduction in minimum capital standards for any large number of banks.

I have testified before this committee before that the standard of 3 percent as a minimum standard would reduce the minimum standard for substantial majority of all the banks in the country and primarily the small banks. We think that is unwise and that is why we have not been willing to agree that a 3-percent tandem standard is the appropriate standard.

In this regard, the Federal Reserve has now put out their standard, and I think really in the spirit of compromise to use the 3-per-

cent number in order hopefully to get some kind of agreement with the Comptroller adopted the 3-percent, but said that that only applied to the highest level of bank ratings, camel one banks.

The fact of the matter is that there are practically no camel one banks with 3-percent capital because they all have more than that.

We agree, however, with the Federal Reserve's definition, which in substance means that practically every bank in the country would have to have 4 or 5 percent based on the assets and the risk of assets in the institutions.

This is a somewhat awkward way to move toward a compromise I must say. We would have preferred to go to a standard which would not have reduced minimum requirements for the great majority of banks, which we find to be somewhere around 4½ percent rather than the 3-percent number.

However, we have no problem with the Federal Reserve's proposal as it has been adopted. Our staff has come up with a comparable recommendation which it will be putting to our Board. But since our Board has two of the gentlemen who are with us today, you can see that there may not be total unanimous agreement with the staff recommendation.

I think above all it is important that we get uniform standards and, as I say, insofar as the FDIC is concerned, we would prefer to have a 4½-percent tandem standard, but we find the Federal Reserve proposal satisfactory and it arrives at substantially the same result. So our staff is going to propose to our Board that we adopt the same standard as the Federal Reserve has adopted.

Now this disagreement may sound like regulators splitting hairs. I mean 3 percent and 4½ percent, well, there is 1½ percent difference, but it is a very material difference when one looks at the banking system and sees that at 3 percent substantially all banks, all smaller banks would have lower minimum standard.

So we believe a prudent minimum leverage requirement must be maintained as a check on institutions with only limited credit risk, but with significant exposure to other risks, and particularly including interest rate risk.

In that regard, the international group is coming up with an interest rate risk test that is a very complicated test, but it would move to meet some of the problems that we have been discussing, but at this point of course it is not in place, and I don't think it will be for some time, and that makes it urgent that we reach an agreement on the core capital leverage ratio.

If we were to go to 3 percent, then guidance must be given, as the Federal Reserve has given on how the 3 percent applies, and we do not find that in the present situation.

As you know, if you look at banks today, most banks have loan loss reserves in the area of 1 to 2 percent. And since the required amount is 5½ to 6 percent, that almost automatically gives you the number that something around 4 percent is where bank capital is today on an overall average basis.

I would hope, and I have hoped all during this discussion that has been going on since last October that reasonable men could agree on a standard here. I consider my good friend and doubles partner in tennis, Mr. Clarke, to be a reasonable man in almost all respects, but we have not been able to arrive at a conclusion in

this. I hate to implore help from the outside, but at this point all I can do is say that we have done our best to try to reach an agreement and have not been able to do so.

[The complete prepared statement of William Seidman follows:]

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

ACCOUNTING AND CAPITAL STANDARDS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

10:00 A.M.
MONDAY, AUGUST 10, 1990
Room 538, DIRKSEN SENATE OFFICE BUILDING

Good morning, Mr. Chairman and members of the Committee. We appreciate this opportunity to testify on the accounting and capital standards for federally insured depository institutions and the differences in these standards among the federal banking and thrift supervisory agencies. In accordance with Section 1215 of the Financial Institution's Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Federal Deposit Insurance Corporation has submitted a detailed report to the Committee on Banking, Housing, and Urban Affairs regarding these differences.

In your letter of invitation, we were asked to discuss:

- the adequacy of generally accepted accounting principles (GAAP), based on historical cost, in promoting the safety and soundness of financial institutions;
- the differences in accounting and capital standards among the various agencies and how we are working to resolve them; and
- our comments on simplification and reduction of differences in accounting and reporting standards.

GAAP as the Reporting Standard

The regulatory reporting standards followed by the three federal banking agencies -- the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the FDIC -- are substantially consistent with GAAP as

applied by commercial banks. Over the years, the three agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), have developed uniform Reports of Condition and Income -- also known as "Call Reports" -- for all commercial banks and FDIC-supervised savings banks. The uniform Call Report serves as the starting point for calculating banks' risk-based capital and leverage ratios, and is used extensively for other regulatory purposes. Thus, differences in accounting and reporting standards do not exist among commercial banks and FDIC-supervised savings banks.

The Office of Thrift Supervision requires each thrift institution to file a "Thrift Financial Report" (TFR), based on GAAP as it is applied by thrifts. However, the TFR differs greatly from the bank Call Report in both the information required and its form of presentation. While some of these differences arise from differences in GAAP between banks and thrifts, others arise from the banking agencies' adoption of regulatory reporting standards that affect reported levels of capital in ways which are more conservative than bank GAAP.

Fair presentation of the financial affairs of a depository institution is the goal of GAAP financial statements. The FDIC's primary interests are the safety and soundness of insured financial institutions and the protection of the insurance funds. The agencies support GAAP as the overall reporting

framework and expect banks to follow GAAP for regulatory reporting unless our standards require a different treatment. Departures from GAAP arise where the banking agencies believe a different approach better enables us to assess banking risks. A review of the so-called RAP-GAAP differences for banks clearly shows that RAP does not improve the reported financial condition of banks. In fact, RAP tends to produce lower bank earnings and capital, and higher total liabilities.

Reporting Differences

Several variances in regulatory reporting between banks and thrifts reflect the different approaches of the banking agencies. The most significant difference involves assets sold with recourse. The member agencies of the FFIEC are currently considering whether to eliminate differences between bank regulatory reporting and GAAP for sales of assets with recourse. The opportunity to do away with this difference results from the introduction of risk-based capital standards which explicitly require capital for off-balance sheet exposures. The agencies anticipate input in response to the June 1990 "Request for Public Comment on Recourse Arrangements." We hope to revise bank reporting standards to eliminate differences among regulators without sacrificing safety and soundness considerations. Accounting for excess servicing fees and a change in the regulatory reporting treatment for these receivables also may be considered.

The banking agencies' concern about the apparent breadth of acceptable practice in accounting for financial futures contracts, particularly as this relates to the deferral of losses, results in the current difference in accounting for these instruments between banks and thrifts. However, the FFIEC's Task Force on Reports is working to draft appropriate regulatory reporting safeguards to permit all institutions to account for futures contracts in accordance with GAAP. The reporting of in-substance defeasance of debt in accordance with GAAP is not permitted for bank regulatory reporting purposes because of uncertainty regarding the irrevocability of trusts established for defeasance purposes.

Another apparent difference between thrift and bank regulatory reporting concerns a general valuation allowance for loan losses on troubled real estate loans. Thrifts often use specific valuation allowances for individual loans and, for those loans with specific reserves, do not seem to provide for an additional general allowance. We expect the general allowance to include an amount that reflects the risk of error in the specific loss estimates, and believes that this method is encompassed by GAAP. The FDIC is having intensive dialogue with institutions about the adequacy of their loan loss allowances. The GAAP rule, even for thrifts, leaves considerable room for judgment and, needless to say, our judgment frequently calls for a larger reserve than management believes is necessary.

Several reporting differences between banks and thrifts result from differences in GAAP itself. The FDIC has long supported eliminating the variations between GAAP for banks and thrifts. Last November, we wrote to the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) to urge the elimination of existing differences in bank GAAP and thrift GAAP. The FDIC requested their assistance because of the increasing similarity of the banking and thrift industries and to satisfy the Congressional mandate to adopt uniform regulatory accounting standards for all depository institutions.

In response to our request, the FASB notified the FDIC that it is considering a limited scope project on whether and how a financial institution should discount estimated cash flows from collateral in determining loan losses. Thrifts use a net realizable value approach which discounts cash flows basically at the institution's cost of funds. For banks, a fair value approach which incorporates an investor's desired rate of return as the discount rate is normally followed. If the FASB resolves this issue, it will eliminate one of the major differences between bank and thrift GAAP which affects all loans with real estate collateral and possibly the valuation of all foreclosed real estate. The FDIC continues to urge the banking and thrift committees of the accounting profession to merge and unite their audit guidelines. The duplication of effort between these two functions remains a serious hindrance to consistent accounting practice.

In addition, the FASB has indicated that it will be addressing the issue of disclosure of market value information as the next step in its ongoing financial instruments project. The FDIC has not supported using market value accounting in place of historical cost accounting as the basis for preparing depository institutions' financial statements. Our concern is based primarily on the great difficulty in obtaining reliable market value estimates for many bank or thrift assets and the cost of doing so. Market values would also have to be determined for the liability side of the balance sheet. A valuation of an institution's intangibles must be considered as well. Nevertheless, additional disclosure of market values where available would certainly assist both regulators and the public.

The AICPA's Accounting Standards Executive Committee has been addressing two other issues that have caused differences in accounting practice between banks and thrifts. The Committee's proposal requires the use of market or fair values in certain circumstances and will provide a more realistic and conservative picture of an institution's financial position. First, the exposure draft of an AICPA proposed statement on "Reporting by Financial Institutions of Debt Securities Held as Assets" would more clearly indicate when assets should be reported at the lower of cost or market value rather than at historical cost. The proposal provides guidance on evaluating whether an institution plans to sell securities in the foreseeable future.

Second, a proposed draft of an AICPA statement on "Accounting for Foreclosed Assets" would require a lower of cost or fair value accounting treatment for foreclosed assets such as other real estate held by both banks and thrifts. With the addition of certain safeguards and assurances, we urge early adoption of these two proposals.

Capital Differences

With regard to capital requirements for banks and thrifts, a number of changes have taken place in recent years and further revisions are expected by the FDIC before year-end.

In response to Section 908 of the International Lending Supervision Act of 1983 and other factors, the three federal banking agencies adopted uniform capital rules for all banks in 1985. That standard is 5.5 percent primary capital to book assets and six percent total capital.

In the first quarter of 1989, the FDIC and the other banking agencies issued risk-based capital guidelines. Under the guidelines, banks are to meet an interim minimum ratio of capital to risk-weighted assets of 7.25 percent by year-end 1990 and a final minimum ratio of eight percent by year-end 1992. At least one-half of this total capital requirement is to be comprised of Tier 1 capital elements. For most banks, Tier 1 capital is equal to their common equity capital, less intangible assets such as goodwill.

In accordance with FIRREA, the OTS adopted a risk-based capital framework for savings associations that became effective on December 7, 1989. Upon adoption of the new framework, thrifts were required to meet a 6.4 percent risk-based capital minimum. This risk-based standard is scheduled to increase to 7.2 percent by year-end 1990 and eight percent by year-end 1992. OTS also adopted a three percent core capital leverage test. Currently, there is no direct bank corollary to OTS' core capital leverage test. However, it appears to be lower than the OCC's current 5.5 percent primary leverage capital requirement for national banks even when adjusted for the loan loss reserve.

The banking agencies' existing uniform leverage requirements are based on a definition of primary capital plus secondary capital and the agencies are in various stages of revising these standards so that the capital definitions would more closely track those used in the risk-based capital framework.

In the process of adopting risk-based guidelines and revising the capital definitions for the leverage standard, we hope that the agencies will avoid any meaningful reduction in minimum capital requirements. At the same time, we are trying to coordinate our minimum capital standards with those that have been established or proposed by the other federal banking and thrift regulators. In this regard, the FRB and the OTS have adopted, and the OCC has proposed to adopt, new minimum leverage standards. The FDIC staff is in the process of devising a

proposed revision to our existing 5.5 percent primary and six percent total capital leverage standards. The FRB and OTS rules and the OCC proposal require institutions they supervise to maintain Tier 1 core capital equal to at least three percent of total assets. While these agencies' core capital leverage standards appear on their face to be the same, the critical issue still unresolved is how these standards should be applied to individual institutions. The FRB rule applies the three percent leverage ratio only to banks in the very best condition, while all other banks will need to maintain a minimum of at least four to five percent.

We agree with the establishment of a revised leverage standard that excludes the allowance for loan losses from the definition of capital. We also note that most banks' loan loss reserves do not exceed more than one to two percent of their assets. As a result, most banks meet the existing six percent total capital leverage standard by having a minimum of at least four to five percent in common equity capital plus their loan loss reserves. Therefore, if loan loss reserves were excluded from a revised definition of capital, we believe a minimum leverage standard of at least four to five percent would be appropriate for the great majority of banks. It would also accomplish our objective of avoiding a reduction in capital standards.

To the extent that a lower absolute minimum such as three percent is allowed for any bank, we agree with the Federal Reserve's position that a lower leverage standard should be acceptable for only the most highly-rated banks (those rated "one" on the interagency scale) and only if these institutions are not anticipating or experiencing significant growth or expansion of activities. We feel strongly that a four-to-five percentage leverage ratio is the minimum acceptable level for institutions that are not among the most highly rated.

Moreover, because the existing risk-based capital standards focus primarily on credit risk and largely ignore interest rate risk and operational risks, a prudent minimum leverage requirement must be maintained as a check against institutions with limited credit risk but with a significant exposure to other risks that are not credit related. On the other hand, the OCC's proposed revision of its leverage standards merely specifies that each national bank must meet a minimum core capital leverage ratio of three percent. No guidance is provided on which institutions are entitled to get by with three percent and how much more capital the others need to maintain. While we believe it is imperative for the agencies not only to have the same minimum capital standards on paper, it is even more important to apply these minimum standards in the same way in practice. The OCC and the FDIC have not yet been able to come to an agreement on this point.

It should also be noted that FIRREA requires that OTS adopt capital rules equivalent to those in effect for national banks.

OTS already has in place a three precent minimum core capital leverage standard which should in theory result in institutions that are not in the best condition being required to maintain higher levels of capital. However, it is not clear to us that OTS has a firm policy of establishing higher minimums for individual institutions that are in a less than fully satisfactory condition.

We hope to issue our revised leverage proposal in the near future and finalize action on a new standard by year-end 1990 -- the date when the first minimum risk-based capital ratio for banks must be met.

Differences in Bank and Thrift Capital Standards

As discussed in our report to the Committee, there are a number of differences between the way the banking agencies measure capital for banks and the manner in which OTS measures capital for savings associations. Most notable among these differences are the treatment of goodwill, subsidiaries, and transactions with recourse arrangements.

Banks currently must deduct goodwill in calculating regulatory capital. However, up to one-half of a thrift's three percent core capital requirement currently can be represented by "qualifying supervisory goodwill." Over a

five-year phase-out period, savings associations gradually will be eliminating the qualifying supervisory goodwill that can be included in their regulatory capital calculations.

As discussed earlier, efforts are underway to reduce differences among the banking and thrift agencies with respect to the capital treatment for transactions involving off-balance sheet recourse arrangements. Responses to the June 1990 "Request for Comments on Recourse Arrangements" will be carefully evaluated. These comments will help the agencies reach a uniform and prudent supervisory approach for determining how capital standards should apply to the various types of recourse arrangements.

Several factors account for the differences in the capital treatment of subsidiaries by banking and thrift regulators. For example, due to FIRREA, a savings association subsidiary that engages in any activities impermissible for national banks is required to be "separately capitalized" by the parent thrift, rather than consolidated, for OTS regulatory capital purposes. On the other hand, the FDIC generally requires state nonmember banks to "separately capitalize" only securities subsidiaries that are established pursuant to section 337.4 of the FDIC's regulations. Other bank subsidiaries are generally consolidated when calculating a bank's regulatory capital.

The OTS also requires most "less than majority-owned" subsidiaries to be subject to consolidation on a pro-rata basis. On the other hand, the FDIC normally treats an institution's investments in such entities in the same way as any other asset. We would require pro-rata consolidation only if the specific circumstances deemed such an approach to be appropriate on a case-by-case basis.

The issue of whether majority-owned subsidiaries of banks should be consolidated or separately capitalized continues to be discussed, particularly as it relates to the future structure of the banking industry and the deposit insurance system. Today, some state-chartered banking institutions are authorized to engage in nontraditional banking activities, in accordance with certain laws that already have been enacted by the state legislatures. Examples of these activities include insurance underwriting -- as recently authorized by Delaware -- and real estate development. As the structure of the banking industry evolves and changes over time, it is possible that other nontraditional activities will be authorized in the future.

Riskier and nontraditional activities should be financed through owners' equity or other outside sources of funds, rather than through the use of insured deposits. If the activities permitted for banks and thrifts continue to expand to include securities underwriting, real estate development, insurance

underwriting, and other nonbanking activities, adequate capital cushions will be needed. These activities should be conducted through separately capitalized bona-fide subsidiaries with appropriate safeguards. Otherwise, much higher capital requirements should be established at the parent bank or thrift level.

Capital Requirements for Interest Rate Risk

The federal banking agencies have not proposed a specific interest rate risk component for their risk-based capital requirements. However, on a case-by-case basis, higher capital has long been required for institutions with excessive levels of interest rate risk. Those with only moderate interest rate risk exposures and with no other supervisory problems can conceivably operate closer to the eight percent minimum risk-based capital requirement than those with excessive interest rate risks. However, we do not view the absence of interest rate risk as a "credit" that can be applied to reduce risk-based capital below the eight percent minimum level. Instead, we view the presence of significant interest rate risk as a very strong indication that a capital ratio over and above the eight percent risk-based minimum is warranted.

The FDIC and the other U.S. banking agencies will continue to work with each other and with regulators from other countries and the Basle Committee on Banking Supervision to develop

explicit capital requirements for interest rate risk. The committee has been investigating to see what type of information should be gathered from banks in order to do an adequate assessment of interest rate risk and has devised a measurement tool which regulators here and abroad will be testing. Whatever measurement system is adopted, it should be sufficient to allow regulators to supervise institutions without imposing regulators as the institution's de facto managers. In the interim, close supervision and higher capital will continue to be required for those institutions with undue levels of interest rate risk.

Reliability of Financial Information

Since the reliability of financial information is vital to our supervisory efforts, we are implementing several accounting and capital initiatives. We expect these initiatives to promote more reliable bank and thrift financial information and to enhance our supervisory efforts to maintain a safe and sound financial system. These measures include:

- Increased reliance on a more narrow definition of capital; that is, a definition of Tier 1 or core capital that generally includes only common equity capital, net of intangibles.

- Continued emphasis on ensuring that banks and thrifts promptly recognize charge-offs and nonperforming loans and

that they regularly replenish their general loan loss reserves to levels necessary to adequately reflect the inherent risks in their portfolios. However, while we routinely urge banks to maintain adequate reserves for loan losses, changes enacted to the tax code in 1986 tend to be a disincentive for banks to maintain reserves at the level we believe to be adequate. Large banking organizations are no longer permitted to use the reserve method for taking bad debt deductions for federal income tax purposes even though reserves are required under GAAP for financial reporting purposes. In our view, this tax policy is detrimental to the banking system.

- o Continuing efforts to facilitate early intervention in problem bank and thrift situations, particularly in those instances where some general loan loss reserves might still remain but where equity capital has been exhausted or substantially eroded.

- o A commitment that the exercise of new nontraditional activities, if exercised at all, shall be separately capitalized and insulated from the capital supporting deposits.

These measures should help provide prompt recognition and timely resolution of problem institutions that are no longer viable, economic entities.

Recommendations on Accounting and Reporting Standards

The FDIC, through its participation in the FFIEC Task Force on Reports, is continuing to study ways to eliminate differences between the Call Report standards and GAAP that are consistent with the agencies' supervisory responsibilities. However, since most of the significant differences as they relate to bank regulatory reporting have been resolved or their possible resolution is under study, the primary way to reduce the remaining differences and simplify accounting standards for banks and thrifts is to adopt a more uniform regulatory reporting scheme for all depository institutions.

Although the preparation of both the bank Call Report and the Thrift Financial Report is predicated on GAAP, the required information and the form of presentation in the reports are significantly different. The Thrift Financial Report, for example, requires a great deal more detailed information on assets and their scheduled maturities compared with the bank Call Report. On the other hand, the bank Call Report has certain information needed for deposit insurance assessment purposes that is not included in the Thrift Financial Report. The FDIC staff has begun to identify, starting with deposits, the basic information needed in comparable form from all depository institutions for safety and soundness, insurance assessment, statistical, and economic purposes.

Once the necessary information has been identified, we will be prepared to resolve the differences between the Call Report and the Thrift Financial Report. We are committed to taking the best features of both regulatory reports to create a uniform regulatory reporting framework that can be applied to all 13,000 commercial banks and FDIC-supervised thrift institutions, as well as the 2,500 OTS-supervised thrift institutions. We are also prepared to work closely with the accounting profession on matters of mutual concern.

Improving Auditing of Federally-Insured Depository Institutions

The commentary on Section 1215 of FIRREA in the Conference Committee Report also asked for our thoughts on improving auditing of federally-insured depository institutions. OTS requires audits of financial statements at all thrifts. The banking agencies, however, do not require such external audits because of concerns over: 1) the costs to small institutions versus the benefits; and 2) the paucity of experienced bank auditors in rural areas. Nevertheless, the FDIC has a longstanding policy of strongly encouraging institutions to have an annual audit by an independent external auditor. The FDIC will continue to encourage audits of banks and to monitor the results of these efforts.

In this regard, the FDIC adopted formal policy statements in late 1988 and earlier this year in an effort to improve the audit coverage of supervised banks. An annual item in the Call Report requires each bank to indicate the scope of its external audit program. This enables the banking agencies to monitor the extent and types of external auditing work conducted at banks. Approximately two-thirds of all banks report that opinion audits were performed either of their own financial statements or of their parent bank holding company during each of the past three years. For the calendar year 1989, only 13 of 420 institutions with over $1 billion in assets and 92 of 2,172 institutions with over $150 million in assets (the size threshold at which the Federal Reserve Board requires bank holding companies to be audited) reported having less than full scope external audit coverage.

Effective communications between auditors and examiners are essential to the success of both the audits and the supervision of banks and thrifts. We encourage the exchange of information with an institution's auditors because communication can help to clarify or resolve issues and concerns as they arise and can provide a better understanding of corrective actions that may be appropriate for an institution to take. For several years, FDIC policy has permitted banks to allow auditors to review our examination reports and to attend our examiners' exit interviews with management and meetings with bank directors when invited by the bank. Section 931 of FIRREA now mandates that institutions

furnish their most recent report of examination to their auditors and we have so advised the banks we supervise. The American Institute of Certified Public Accountants (AICPA) has also been addressing the issue of communication and has drafted a proposed Statement of Position (SOP) on "Inquiries of Representatives of Financial Institution Regulatory Agencies." The SOP would indicate that examination report reviews, discussions with examiners, and attendance at exit interviews are vital elements of sound auditing practice.

In the past year, the FDIC entered into an agreement with the Florida Board of Accountancy that, if our examiners or liquidators encounter what appears to be substandard auditing work by an accountant in an institution in that state, we will refer the accountant to the state board for possible disciplinary action. In an effort to improve the reliability of audits, the FDIC and the other member agencies of the FFIEC have had discussions with the AICPA and the National Association of State Boards of Accountancy regarding the agencies' participation in such disciplinary referral programs nationwide. We hope to have some referral procedures in place during 1991.

Thank you for your attention. I will be happy to answer any questions on my testimony or the FDIC's report.

The CHAIRMAN. Well, I appreciate what you have said, and before we move on I think it's fair to say that the country wants and very much needs strong and competent independent regulators, and there are going to be issues that arise where there will be professional differences of opinion, and I think that is to be expected.

But at the same time, I think after some reasonable length of time and the exchange back and forth issues do have to be settled because there is enough stress out there on the banking system and in our economic system that we don't need any more that comes from uncertainty that it can otherwise be taken away by resolving these issues.

I'm going to have some questions along that line, but it might be just appropriate before we go next to Mr. Ryan to ask, Mr. Clarke, having just heard what sounds like an offer on behalf of Mr. Seidman to go with the Fed position, would that be something you could do, too?

Comptroller CLARKE. Mr. Chairman, if I may, I would like to have a chance to respond to that because, unfortunately, I think we're talking about something that doesn't really justify the amount of time and effort that is being expended debating it.

In fairness to Chairman Seidman, we have not yet published our final risk-based guidelines which contain our final version of the tandem leverage ratio. But, I think when it is published, all will see that the differences between what the Fed has published as their final rule and what we will publish as our final rule are extremely minimal. I would like to quote to you from our final rule which says that the 3 percent leverage ratio is acceptable only for a bank that has excellent control systems, high asset quality and well managed on-balance sheet and off-balance sheet activities. The Fed's statement, as you know from having read it, establishes virtually the same type of criteria for banks that would be allowed to operate at the minimum leverage ratio. As Chairman Seidman has indicated, there aren't very many banks that meet all of those criteria.

So we would expect that most banks, as they do today, would operate at higher levels than the minimums, whether they be the risk-based minimum or the tandem leverage ratio minimum.

Now I would also go on to say that, as you know so well, and as all of us at this table know so well, bank supervision is a judgment business. Under our old 5½ percent and 6 percent guidelines, which we are phasing out at the end of this year, those were minimums. Most banks operated at levels above those minimums, and the levels that we required them to operate at above those minimums were decided on a case-by-case basis. I would expect that we would do exactly the same thing under these new risk-based and tandem leverage ratio standards.

What we have done is set out a minimum leverage ratio and a minimum risk-based standard and say that only the very best banks are going to be allowed to operate at either of those minimums. We will use our judgment, as we have in the past, and as all the agencies have done in the past, to set the higher levels.

Finally, I would underscore the point that I made in my oral statement, that we have all embraced the risk-based capital stand-

ards. Not only is it part of an international agreement, but it's an agreement domestically among all the Federal bank regulators. Congress, as I indicated, embraced the concept of risk based capital in FIRREA for thrift institutions.

It is very important that we allow the risk-based capital standards to work because they are a material improvement. If you look at the number of banks that don't meet the risk-based standards today, and certainly the number that didn't meet the standards at the time we embraced them, compared to the number of banks that don't meet our old standards, you'll see that the risk-based standards have resulted in a substantial amount of additional capital being required in the banking system.

We need to give those guidelines a chance to work, and at the same time we need to backstop those guidelines with a minimum leverage ratio which in most cases will be substantially higher than the minimum that we've set out. I hope we can get this resolved.

The CHAIRMAN. Mr. Seidman, we would like to hear your response.

Chairman SEIDMAN. Well, Mr. Chairman, I would only say that if the 3 percent doesn't apply to anybody, it seems to me that it's not reasonable to say that it arrives at a perfect balance between the leverage ratio and the risk based ratio. I mean it's almost becoming something of an Alice in Wonderland. In fact, we searched and we couldn't find anybody. However, we may have missed one or two.

The other point I would make is that our study shows that without a number higher than 3 percent, approximately 10,000 banks' minimum capital standards will be reduced. That is what we oppose. We, of course, are the primary Federal regulator for small banks, and those are essentially what we're talking about, and it seems to me that we ought to be able to get over this one.

All we're saying is we don't want 10,000 banks to believe that their minimum capital standards have been reduced.

The CHAIRMAN. May I just ask one other thing before going to Mr. Ryan to you, Mr. Seidman, and that is, you know, we have been pretty badly burned by the call on citizens to back up the deposit insurance fund on the savings and loans side, and we're down to a pretty modest balance in the banking insurance fund.

I would like you to be as direct as you can be about the degree to which any concern you have on this issue relates to just the basic soundness and strength of the insurance system. I mean do you see a risk there? Does this issue relate to potential risk in terms of the insurance system itself as you would see it?

Chairman SEIDMAN. I think it does relate directly to the safety and soundness of the insurance system because it relates to how much capital banks will be required as a minimum to carry. That is at least our first line of defense, as you have pointed out, or our last line of defense, however you want to put it. However, capital and the amount of capital is clearly an important factor.

Chairman Greenspan gave a speech the other day in which he in effect said capital is the main defense and we need to increase it. I can't find a way, no matter how much I wish to compromise, to agree on a standard that will reduce the minimum standard for 10,000 banks in this country under the current circumstances.

The insurance fund is under substantial pressure, the worst it has had since it has been in business. We are not over the hump yet. We have predicted the possibility of $2 billion of loss in the fund this year. It may be lower, but it could be higher. So I think it is clear that we ought to be doing everything that we can to ensure protection for the fund, and the primary protection beyond the way banks operate is capital.

The CHAIRMAN. Well, gentlemen, I want to come back and pursue this, but I think we ought to hear our other two witnesses and get them on the board here. You both have had a chance to comment twice.

So we'll go now to Director Ryan and then to Board Governor Angell, and then come back and we can pursue this further.

Director Ryan, we are pleased to have you.

STATEMENT OF TIMOTHY RYAN, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Director RYAN. Good morning, Mr. Chairman and Senator Bond.

The CHAIRMAN. Oh, excuse me. I'm sorry.

Senator Bond has come in.

Senator Bond, would you like to make an initial comment at this time?

Senator BOND. Thank you, Mr. Chairman, I have a couple of questions that I might want to pursue afterward, but I would be interested in hearing the other two witnesses before we get into those questions.

The CHAIRMAN. Very good.

Director Ryan.

Director RYAN. Thank you.

Capital and accounting standards are of paramount importance in policing the health of the thrift industry as they are two of the most important tools we use to ensure that the industry operates in a safe and sound manner. Taken together, they determine the amount of private risk capital that is required of banks and thrifts.

As the Congress recognized when it passed FIRREA, capital is the primary buffer between losses at insured institutions and the Federal deposit insurance funds, and ultimately the taxpayers. The losses that the S&L industry's insurance fund has suffered over the past several years are primarily attributable to the fact that some associations took risks that were far too great with far too little of the owners' money at stake.

Accounting standards are the yardsticks used to measure capital. The accounting standards must represent the economic substance of transactions and need to incorporate safety and soundness considerations. The reported capital should fairly represent the amount of equity that is at risk in the normal course of safe and sound operations.

The absence of strong capital and accounting standards in the thrift industry in the early and mid-1980's created intolerable risky incentives, deferred recognition of the industry's problems, and delayed their resolution. They amounted to a ticking time bomb.

President Bush and Congress recognized their importance and in FIRREA appropriately required OTS to strengthen both its mini-

mum capital standards and its accounting standards. I support personally both of these goals and OTS has adopted standards to fulfill this legislative mandate.

Last month, I sent to Congress OTS's report on the differences that remain between the capital and accounting standards that OTS imposes on thrifts and those imposed on banks. As the report suggests, Mr. Chairman, while there remains some differences, many I might add, due to specific statutory requirements, the standards are remarkably similar.

We will continue to work cooperatively with the bank regulators to ensure consistent and appropriate regulatory requirements.

By way of background, my written statements sets forth the unfortunate history of weakened thrift capital and accounting standards in place during the early 1980's. These policies have now been corrected by FIRREA. FIRREA directed the newly created OTS to match the capital and accounting rules that applied to national banks. As the reports submitted by the OTS and our fellow regulators illustrate, we have moved to adopt such standards. We are also taking actions to further harmonize the standards.

Many of the remaining differences between our capital rule and those of the bank regulators are due to statutory requirements. This is true of the two most significant differences in our rules, the treatment of goodwill and the treatment of investments in certain subsidiaries. Both of these areas are addressed specifically in FIRREA, and in both cases the differences will be eliminated over time.

The other major area of difference relates to assets sold with recourse. OTS has already taken a tough position on recourse issues since risk-based capital rule went into effect last December, and the five Federal depository institution regulators are working through the Federal Financial Institutions Examination Council to finalize a rule appropriate to all agencies.

I want to emphasize the OTS capital rules, like those of the other banking agencies, are minimum standards. All institutions are responsible for having adequate capital reserves to protect themselves and the insurance fund from risk. We expect thrifts to achieve capital levels that are higher than the minimum requirements if higher levels are warranted by the composition of their portfolios or by risks other than credit risk.

As to the appropriate tangible leveraged ratio, as you know, OTS is required to be no less stringent than the OCC. Accordingly, once OCC finalizes its 3 percent tangible leveraged ratio, OTS must be no less stringent once FIRREA is fully phased in.

As you have seen, the debate continues though between my fellow members here of the FDIC. As you know, I'm now closing my first 6 months, and I'm listening intently to the debate and, quite frankly, to what should really be the appropriate minimum tangible leverage ratio.

As the Chairman has said, that debate will continue very soon within the FDIC, and I look forward to listening to my colleagues and making up my own mind on that issue, but I will stress I do have an open mind on that question today.

My report to the committee also highlighted the remaining differences in accounting standards between OTS and the banking

agencies. These differences occur both in policies and in practices. Where the insurer and the primary regulator are both examining the same institutions, they are a natural outgrowth of the tension built into the regulatory structure.

As in the capital area, we have launched an effort with our fellow regulators to continue to work to narrow down, if not eliminate completely, the remaining differences in accounting standards.

We also intend to propose a rule soon that will take advantage of the flexibility given to us in FIRREA to adopt supervisory accounting and reporting standards that are more stringent than GAAP in those areas where we believe that such action is necessary to adequately protect the insurance funds.

There are several important areas of accounting where we believe that the range of acceptable practice under GAAP is simply too broad for safety and soundness reporting purposes.

A major project that is underway that may help to ensure more useful accounting standards and improve capital adequacy is a review of the feasibility of adopting market value accounting. The Treasury Department, as required by FIRREA, is undertaking a study of reforms to the Federal deposit insurance system, including the use of marketing value accounting. Market value accounting would be useful in ensuring that we have sufficient information to monitor the true economic condition of institutions.

While historical cost accounting may have been adequate when prices and interest rates were stable, it is inadequate to cope with a volatile financial marketplace as we now have. Market value accounting should aid in assessments of risk and in the identification of those institutions with economically impaired capital.

This is not to say that the adoption of market value accounting is the cure all for potential problems. There are many questions that need to be answered before it could be adopted, including those of accuracy and reliability of measurement, appropriate methodologies for calculation and the costs of implementation.

An important point to keep in mind, however, is that the benchmark that we should use to compare market value accounting is not perfect information. Rather, it is GAAP information, with all of its intrinsic limitations.

[Senator Bond fixes the humming noise from the mikes.]

The CHAIRMAN. What a display of technical wizardry by Senator Bond there. [Laughter.]

Senator BOND. We did it together on a bipartisan basis. [Laughter.]

The CHAIRMAN. We may send you out to Andrews Air Force Base and see if you could apply some of that.

Senator BOND. I would rather catch a plane. [Laughter.]

Director RYAN. The Treasury Department's report will address the issue of market value accounting. At this point I am uncertain as to whether it is workable. If it is, however, it could become one of the most important tools for ensuring accurate information on the financial state of insured institutions.

Besides the review of market value accounting, another major project underway is a proposal on interest rate risk. While the existing bank and thrift capital standards are chiefly directed toward

credit risk, FIRREA recognizes that other types of risk also need to be addressed. In particular, the statute explicitly permits OTS to add an interest rate risk component to its capital rule. In my view, this is important for OTS to look at this issue.

Because thrift industry assets are heavily concentrated in mortgage loans, which are typically long-term assets, interest rate risk will continue to cause substantial risk to the industry. As a result, I believe it is necessary to make our risk-based capital rule explicitly sensitive to interest rate risk.

Thank you, Mr. Chairman and Senator Bond for your patience and for the opportunity here to present our views.

The CHAIRMAN. Very good, Director Ryan. We appreciate those views.

[The complete prepared statement of Timothy Ryan follows:]

TESTIMONY OF

TIMOTHY RYAN, DIRECTOR

OFFICE OF THRIFT SUPERVISION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

September 10, 1990

Thank you for the opportunity to testify before this Committee on the capital and accounting standards that the Office of Thrift Supervision requires of savings associations.

Capital and accounting standards are of paramount importance in policing the health of the thrift industry, as they are two of the most important tools we use to ensure that the industry operates in a safe and sound manner. Taken together, they determine the amount of private risk capital that is required of banks and thrifts.

As the Congress recognized when it passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989, capital is the primary buffer we have between losses at insured institutions and the Federal deposit insurance funds -- and, ultimately, the taxpayers. The losses that the savings industry's insurance fund has suffered over the past several years are primarily attributable to the fact that some associations took risks that were far too great with far too little of the owners' money at stake.

Accounting standards are the yardsticks used to measure capital. The accounting standards must represent the economic substance of transactions and need to incorporate safety and soundness considerations. The reported capital should fairly represent the amount of equity that is at risk in the normal course of safe and sound operations.

The absence of strong capital and accounting standards in the thrift industry in the early and mid-1980s created intolerably risky incentives, deferred recognition of the industry's problems, and delayed their resolution. They amounted to a ticking time-bomb.

Congress recognized their importance and, in FIRREA, appropriately required OTS to strengthen both its minimum capital standards and its accounting standards. I support both of these goals and we have adopted standards to fulfill the legislative mandate.

Last month, I sent to Congress OTS's report on the differences that remain between the capital and accounting standards that OTS imposes on savings associations and those imposed on banks. As the report suggests, while there remain some differences -- many, I might add, due to specific statutory requirements -- the standards are remarkably similar. We will continue to work with the bank regulators to ensure consistent and appropriate regulatory requirements.

HISTORY

By way of background, it is useful to understand the important changes that have taken place in the capital and accounting standards that applied to thrifts over the past decade. To many observers, the thrift crisis was due, in part, to the weak capital and accounting standards in place during the early 1980s.

For example, in 1980, the Federal Home Loan Bank Board lowered the minimum capital requirement (a form of "leverage ratio" based on GAAP) from 5% to 4%, and to 3% in 1982. Further, thrifts were allowed to use the "5-year averaging" and "20-year phase-in" provisions of the rule to further reduce their capital requirements. The 5-year averaging rule permitted institutions to average their insured accounts over the prior 5 years to determine capital requirements, thus minimizing the capital requirements for thrifts that were experiencing fast growth. Similarly, the 20-year phase-in rule allowed associations to gradually -- over a 20-year period -- meet their capital requirements.

In 1981, the Bank Board allowed thrifts to include "deferred loan losses" in their calculation of capital, substantially inflating the "reported" capital strength of institutions. Finally, in 1982, the Board allowed for the inclusion of "appraised equity capital" -- the difference between book value

and fair market value of selected assets. When the Board finally began increasing its capital standards in the mid-1980s, it adopted a phase-in policy that was tied to industry profitability and that pushed the effective date of the new standards beyond the horizon.

These policies had a disastrous effect on the incentives for thrift owners to operate in a prudent manner. They are all now gone.

FIRREA directed the newly-created OTS to match the capital and accounting rules that applied to national banks. As the reports submitted by the OTS and our fellow regulators illustrate, we have moved to adopt such standards. We are also taking actions to further harmonize the standards.

CAPITAL

Many of the remaining differences between our capital rule and those of the bank regulators are due to statutory requirements. This is true of the two most significant differences in our rules -- the treatment of goodwill and the treatment of investments in certain subsidiaries. Both of these areas are addressed specifically in FIRREA, and in both cases the differences will be eliminated over time, as the "phase out" periods end.

The other major area of difference relates to assets sold with recourse. "Recourse" arises when institutions sell assets with the promise to reimburse the purchaser if certain losses arise. These promises make it easier to sell assets, but they raise concerns about the liability kept by the selling institution. OTS has already taken a tough position on recourse issues since our risk-based capital rule went into effect last December. The five Federal depository institution regulators have issued, through the Federal Financial Institutions Examination Council (FFIEC), an advanced notice of proposed rulemaking that solicits comments on the appropriate treatment of asset sales with recourse in measuring risk-based capital requirements. Our goal is to adopt uniform capital regulations on recourse transactions as soon as practically possible.

I want to emphasize that our capital rules -- like those of the other banking agencies -- are minimum standards. All institutions are responsible for having adequate capital reserves to protect themselves -- and the insurance fund -- from risk. Our current risk-based capital rules are primarily designed to address one risk -- credit risk. Financial institutions, however, are subject to other risks that must be taken into account in determining capital adequacy. We expect savings associations to achieve capital levels that are higher than the minimum requirement if higher levels are warranted by the composition of their portfolios or by risks other than credit risk.

It is also important for regulators to be able to take necessary action to resolve problem thrifts soon enough to prevent significant losses to the insurance fund. Congress improved our authority to take such "early intervention" action in FIRREA. I expect to propose a new rule in the near future that will help articulate clearly the standards we will use in invoking this authority.

ACCOUNTING

My report to you also highlighted the remaining differences in accounting standards between OTS and the banking agencies. These differences occur both in policies and in practices. Where the insurer and the primary regulator are both examining the same institutions, they are a natural outgrowth of the tension built into the regulatory structure.

As in the capital area, we have launched an effort with our fellow regulators to continue to work to narrow down, if not eliminate completely, the remaining differences in accounting standards.

Under the auspices of the FFIEC, we are working to harmonize the reporting of assets held for "investment" purposes versus those held in "trading" accounts or held "for sale." This is an

important issue because GAAP imposes significantly different reporting requirements on these two types of assets. The accounting profession, mainly in response to efforts by the OTS, is also addressing this issue.

We also intend to propose a rule soon that will take advantage of the flexibility given to us in FIRREA to adopt supervisory accounting and reporting standards that are more stringent than GAAP in those areas where we believe that such action is necessary to adequately protect the insurance funds. There are several important areas of accounting where we believe that the range of acceptable practice under GAAP is simply too broad for safety and soundness reporting purposes.

MARKET VALUE ACCOUNTING

A major project that is underway that may help to ensure more useful accounting standards -- and improve capital adequacy -- is a review of the feasibility of adopting market value accounting. The Treasury Department, as required by FIRREA, is undertaking a study of reforms to the Federal deposit insurance system, including the use of market value accounting. Market value accounting would be useful in ensuring that we have sufficient information to monitor the true economic condition of institutions.

8

While historical cost accounting may have been adequate when prices and interest rates were stable, it is inadequate to cope with the volatile financial marketplace we now have. Market value accounting should aid in assessments of risks and in the identification of those institutions with economically-impaired capital.

When depository institutions are closed due to a deficiency of capital, all too often the losses to the insurance fund greatly exceed the losses that one might expect based on the institution's published financial statements. It is the market value of assets and liabilities -- rather than the accounting values -- that determine the FDIC's risk exposure. Focusing on economic value should lead to a better allocation of supervisory and examination resources and should prompt corrective action sooner, reducing insurance fund losses. The thrift crisis has demonstrated to all of us this need for timely intervention.

This is not to say that the adoption of market value accounting is the "cure all" for potential problems. There are many questions that would need to be answered before it could be adopted, including those of accuracy and reliability of measurement, appropriate methodologies for calculation, and the costs of implementation. An important point to keep in mind,

however, is that the "benchmark" that we should use to compare market value accounting to is not "perfect" information. Rather, it is GAAP information, with all its intrinsic limitations.

I do not mean to imply that GAAP-based information is not useful. GAAP has developed over many decades and provides consistent financial information. Nevertheless, GAAP must move toward better reports of the economic value of a financial institution and help us, the regulators, identify economic risks to the insurance fund. If not, GAAP will become increasingly irrelevant as a regulatory tool.

The Treasury Department's report to Congress on revisions to the Federal Deposit Insurance Act -- due in early February -- will address the issue of market value accounting. At this point, I am uncertain as to whether it is workable. If it is, however, it could become one of the most important tools for ensuring accurate information on the financial state of insured institutions.

INTEREST RATE RISK

Besides the review of market value accounting, another major project underway is a proposal on interest rate risk.

While the existing bank and thrift capital standards are chiefly directed toward credit risk, FIRREA recognizes that other types of risk also need to be addressed. In particular, the statute explicitly permits OTS to add an interest rate risk component to its capital rule. In my view, it is important that OTS do so.

Savings associations have long operated as specialized financial intermediaries, gathering funds (mostly short-term deposits) and making long-term mortgage loans. In stable interest rate environments (from the 1930s to the late 1970s, for example), this practice worked reasonably well. The industry prospered, in part, because interest rates were relatively stable and the average rate paid on short-term deposits rarely rose above the rate earned on mortgages.

The general practice, however, of funding long-term assets with short-term deposits left the industry vulnerable to rising interest rates and interest rate volatility. This is because the industry's liabilities usually reprice faster than its assets. This potential problem became a reality in the late 1970s and early 1980s; the value of the industry's assets plunged, its earnings declined substantially, and thrifts suffered substantial losses.

The extreme swings in interest rates from that time period have abated. Most observers agree, however, that interest rates will continue to be volatile. As a result, interest rate risk will continue to be a concern. Because thrift industry assets are by statute heavily concentrated in mortgage loans (typically long-term assets), interest rate risk continues to cause substantial risk to the industry. I believe it is necessary to make our risk-based capital rule explicitly sensitive to interest rate risk. The principal objectives of an interest rate risk component should be to:

- make capital requirements sensitive to differences in interest rate risk exposure among associations;

- discourage excessive interest rate risk by making such behavior costly; and,

- ensure that sufficient capital is maintained to limit the risk exposure of the deposit insurance fund and to protect taxpayers' interests.

The Treasury Department is currently reviewing a draft OTS proposed rule designed to meet these objectives. Our proposal would measure interest rate risk exposure in terms of an

association's sensitivity to changes in interest rates. This measure will provide a leading indicator of future streams of net interest income and the potential effect changes in interest rates will have on associations' economic value.

Based on data submitted to us quarterly, we would estimate the change in market value of each association due to changes in interest rates. The capital requirement for interest rate exposure would be based on the estimated decline in an association's market value for a given shift in interest rates.

I believe that it is critical for savings associations to maintain levels of capital commensurate with the amount of interest rate risk to which they are exposed. It is equally important to use the powerful incentives of the capital requirements to encourage associations to prudently manage their interest rate risk. The formal incorporation of an Interest Rate Risk Component into the risk-based capital rule would help to ensure a safe and sound thrift industry.

Thank you for the opportunity to offer my views on the capital and accounting standards of the thrift industry. I would be happy to answer any questions you have.

The CHAIRMAN. Let us now go to Governor Angell. We are pleased to have you. We don't get to see you with great frequency, but we welcome you and we would like to hear from you now.

STATEMENT OF WAYNE D. ANGELL, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Governor ANGELL. Mr. Chairman, I am pleased to be here on behalf of the Federal Reserve Board to discuss regulatory accounting standards and capital requirements for depository institutions.

The Federal Reserve has long viewed accounting standards as a necessary step to efficient market discipline and bank supervision. Accounting standards provide the foundation for credible financial statements and other financial reports.

Financial statements prepared in accordance with the General Accepted Accounting Principles, GAAP, are intended to provide information needed to evaluate an enterprise's financial condition and performance. The regulatory financial statements for federally insured commercial banks and savings banks are the Reports of Condition and Income referred to as Call Reports which are currently required to be filed in a manner generally consistent with GAAP. In those few instances, where the call report specifies reporting requirements which differ from GAAP, these requirements are intended to be more conservative than GAAP.

The Federal Reserve Board and other banking agencies have held preliminary discussions with the OTS to study ways in which a more uniform reporting scheme can be developed for all banking and thrift institutions. The Federal Reserve Board is prepared to work constructively to resolve differences between the Call Report and the Thrift Financial Report and urges the Financial Accounting Standards Board (FASB) and the American Institute of CPA's to eliminate the differences in GAAP as applied to banks and thrifts. More uniform reporting by all institutions is an important goal.

A major issue relating to accounting standards is the appropriateness of market value accounting. The problems in our financial system over the last several years have led some to recommend the adoption of market value accounting. It is suggested that the use of this accounting model might lead to a more effective regulation and supervision of financial institutions and to the closure of problem institutions long before they would become insolvent on the basis of financial statements prepared under GAAP.

While market value accounting has theoretical appeal, a number of concerns have been expressed regarding this accounting model that should be considered before dramatic moves toward market value accounting are made. The Federal Reserve is concerned that, without the development of standards for the estimation of market values, financial statements prepared on a market value accounting basis would not be reliable or verifiable by audits and examinations.

The Federal Reserve believes that the studies now underway by the Federal banking agencies and the FASB should provide additional information regarding the appropriateness of market value accounting. It is also important to emphasize that much can be

done to reduce the differences between accounting and economic measures of financial condition and performance without adopting market value accounting.

For a number of years the Federal Reserve and the other banking agencies have been working to strengthen bank capital positions. The Federal Reserve has long viewed adequate capital as essential to protecting the soundness of individual banks and our banking system as a whole.

I would like to elaborate on some of the important benefits that would result from stronger capital requirements. First, a stronger capital position would strengthen the incentives of bank owners and managers to evaluate more prudently the risk and benefits of portfolio choices because a substantial amount of their money would be at risk.

Second, stronger capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. Third, requiring stronger capital positions would impose on bank managers an additional market test, in that they must convince investors that the expected returns justify the commitment of risk capital. Fourth, strongly capitalized financial institutions are in a better position to take advantage of opportunities that may arise. Furthermore, it would not be necessary to apply as rigorous supervisory attention to such institutions. Thus, it is important that regulators make sure that financial institutions are operating not from a minimum capital base, but from a strong capital base.

The risk-based and leverage standards are discussed in more detail in my written testimony and in our report to Congress. The primary supervisory emphasis has shifted to risk-based capital. The banking agencies have generally viewed their capital ratios as minimums and that prudent banking organizations would continue to operate with a cushion above the minimum leverage and risk-based capital ratios. Institutions experiencing or anticipating significant growth are expected to maintain above average capital ratios.

While capital standards generally provide a cushion against losses from operations of a weak loan portfolio, they do not address all risks of an institution. For example, the bank risk-based capital guidelines do not yet address noncredit factors such as interest rate risk and foreign exchange positions.

Interest rate risk has been evaluated in connection with the overall determination of an organization's capital adequacy and financial condition during on-site examinations. Since a conclusive assessment of capital adequacy can be made only after consideration of all the quantitative factors that determine the need for capital, we think it is clear that the time has now come to place greater emphasis on the quantitative measurement of interest rate risk.

To this end the Federal Reserve is working with the other U.S. banking agencies and regulatory authorities on the Basle Supervision Committee to develop methods to measure and address interest rate and other noncredit risk. These methods are necessary to enhance the basic risk-based capital framework.

In considering how best to factor interest rate risk into capital adequacy, we are guided by the following principles:

One, the system should provide incentives to reduce risk.

Two, the system should assess the impact on the firm of interest rate volatility and hedging activities, including proper risk weighting of hedging instruments.

Three, the system should be straightforward so that it can be widely understood.

Four, the data required should not place excessive burdens on the institution.

Five, the system should strengthen U.S. banking organizations so as to enhance their international competitiveness.

While the Board has not officially approved a particular approach to interest rate risk measurement, there are a number of possible approaches that the Board is likely to consider. One alternative might be to require all institutions, regardless of size, to provide detailed information on the maturity and repricing of their assets, liabilities and off-balance sheet exposure. This information would then be used to calculate the institution's interest rate risk exposure and corresponding capital requirement. This approach could impose substantial reporting burdens on institutions with minimal interest rate risk.

Another alternative that the supervisory agencies might explore involves a two-phased approach. Under this approach institutions would be screened by the use of a rather rough measure of interest rate risk derived from minimally enhanced data that is for the most part already available in the call report. For institutions that undertake interest rate risk outside of established parameters, more detailed reporting would be required and could be the basis for a more precise calculation of additional capital requirements.

In summary, Mr. Chairman, the Federal Reserve believes that both capital and accounting standards play an important role in the supervisory process. Stronger capital positions and prompt corrective action by supervisors will help reduce excessive risk taking. The Federal Reserve will continue to work with other supervisory agencies to develop uniform capital accounting standards that achieve these important objectives.

[The complete prepared statement of Wayne Angell follows:]

FOR RELEASE ON DELIVERY
10:00 a.m. EDT
September 10, 1990

Testimony by

Wayne D. Angell

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing & Urban Affairs

United States Senate

September 10, 1990

INTRODUCTION

I am pleased to be here on behalf of the Federal Reserve Board to discuss regulatory accounting standards and capital requirements for depository institutions. Both of these standards play particularly important roles in the supervisory process. Accounting standards, by promoting consistent and accurate financial reports, enhance the ability of supervisors to monitor developments at depository institutions and to identify situations of deteriorating financial conditions that require immediate corrective actions. Capital standards are perhaps even more critical. A strong capital position enables an organization to withstand an unexpected set back and return to financial health, and when that does not prove possible, helps to limit potential losses to the government deposit insurance fund.

The importance of accounting and capital standards, of course, was recognized by the Congress when it enacted the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). FIRREA directed the depository institution supervisory agencies to develop uniform accounting standards for all federally insured depository institutions, and mandated that capital standards for thrifts be no less stringent than those for commercial banks. Furthermore, the Congress asked the agencies to submit reports discussing any differences among their accounting and capital standards by August 9, 1990. The Federal Reserve's report was submitted on that date.

Today, I do not want to repeat all of the details set forth in that report. Rather, I would like to address some important policy issues regarding the accounting and capital standards employed by the Federal Reserve and the other banking agencies. I particularly want to focus upon those issues raised in your letter of invitation, Mr. Chairman, including market value accounting and our view on how the banking agencies might proceed to assess interest rate risk for examination and capital adequacy purposes.

THE ROLE OF ACCOUNTING STANDARDS

The Federal Reserve has long viewed accounting standards as a necessary step to efficient market discipline and bank supervision. Accounting standards provide the foundation for credible financial statements and other financial reports. Accurate information reported in a timely manner provides a basis for the decisions of market participants. The effectiveness of market discipline, to a very considerable degree, rests on the quality and timeliness of reported financial information.

Financial statements and regulatory financial reports perform a critical role for depository institution supervisors. The supervisory agencies have in place monitoring systems which enable them to follow, on an off-site basis, financial developments at depository institutions. When reported financial information indicates that a deterioration in financial condition has occurred, these systems can signal the need for on-site examinations and any other appropriate actions. The better the quality of financial information, the greater the ability to monitor and supervise effectively.

Financial statements provide information needed to evaluate an enterprise's financial condition and performance. Generally accepted accounting principles (GAAP) must be followed in the preparation of financial statements filed with the Securities and Exchange Commission or that otherwise are audited by Certified Public Accountants (CPAs). The regulatory financial statements for federally insured commercial banks and savings banks are the Reports of Condition and Income, commonly referred to as Call Reports. The Call Reports, the form and content of which, by law, are developed by the Federal Financial Institutions Examination Council (FFIEC), are currently required to be filed in a manner generally consistent with GAAP. In those few instances, where the Call Report specifies reporting requirements which differ from GAAP, these requirements are intended to be more conservative than GAAP.

Call Reports include balance sheets, income statements, and supporting schedules providing information on types of loans, securities, and deposits, and the extent of off-

balance sheet activities. Other supporting schedules also provide information on past due and nonaccrual loans and leases, loan losses and recoveries, and changes in the allowance for loan and lease losses. Certain information on the maturity or repricing frequency of securities, loans, and time certificates of deposits is also presented. Furthermore, the Call Report provides information necessary for the calculation of capital ratios.

FIRREA MANDATE FOR UNIFORM ACCOUNTING STANDARDS

As you know, Section 1215 of FIRREA provides that each federal bank and thrift regulatory agency "establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes." As I have explained, the banking agencies, under the auspices of the FFIEC, have in place uniform Call Reports for all commercial banks and savings banks supervised by the Federal Deposit Insurance Corporation (FDIC). The banking agencies base their capital adequacy and other regulatory and supervisory computations on the Call Report. Thus, for the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the FDIC, uniform "accounting standards" for capital and other regulatory purposes are in place.

On the other hand, the Office of Thrift Supervision (OTS) utilizes the Thrift Financial Report (TFR) which differs from the bank Call Report in scope, detail, and definition of terms. Furthermore, the TFR is based entirely on GAAP for thrifts which is somewhat different from GAAP for banks. Some of the reporting differences between banks and thrifts were appropriate given the different type of assets that thrifts typically held. However, FDIC-insured mutual savings banks file the same Call Report as commercial banks and the FDIC has been able to accommodate the differences between these two types of institutions while still preserving comparability and definitional consistency.

Table 1 in the appendix summarizes the primary areas of difference that exist between the reporting standards of the federal banking agencies and the OTS. Some of

these differences, such as those involving loan loss reserves for real estate loans and the valuation of foreclosed real estate, arise from differences between GAAP for banks and GAAP for savings and loans. Other differences arise in those areas in which bank reporting standards are intended to be more conservative than GAAP, such as in the areas of asset sales with recourse, futures contracts, excess servicing, and in-substance defeasance of debt. These areas of difference are discussed in more detail in our report to the Congress.

The Federal Reserve Board and the other banking agencies have held preliminary discussions with the OTS to study ways in which a more uniform reporting scheme can be developed for all banking and thrift institutions. The Federal Reserve Board is prepared to work constructively to resolve differences between the Call Report and the Thrift Financial Report. Also, the Financial Accounting Standards Board (FASB) and the American Institute of CPAs have been asked by the FDIC to consider eliminating the differences in GAAP as applied to banks and thrifts. More uniform reporting by all institutions is a goal of the Federal Reserve Board.

MARKET VALUE ACCOUNTING

A major issue relating to accounting standards is the appropriateness of market value accounting. Under market value accounting, an institution's assets, liabilities, and off-balance sheet items would be reported in financial statements at their market values. Alternatively, market values could be disclosed in supplemental schedules without affecting the balance sheet and income statement.

The problems in our financial system over the last several years have focused attention on the differences that often exist between accounting and economic measures of the financial condition and performance of banking and thrift institutions. Market value accounting has been proposed by some as a way to narrow these differences between accounting and economic measures. It is argued that the use of market value

accounting might lead to more effective regulation and supervision of financial institutions and to the closure of problem institutions long before they would become insolvent on the basis of financial statements prepared under GAAP.

While market value accounting has theoretical appeal, a number of concerns have been expressed regarding this accounting model that should be considered. One major potential problem is that market values do not exist for a large portion of a financial institution's assets and liabilities and standards have not been developed for the estimation of reliable market values for these items. In addition, the overall cost and reporting burden associated with market value accounting could be considerable, including the cost of verifying market value quotations and estimates during audits and supervisory examinations. Furthermore, market value accounting could result in more volatility in the reported financial condition and earnings of financial institutions.

Clearly, information about the economic value of financial institutions is beneficial for supervisory purposes. However, the Federal Reserve believes that the preceding issues should be thoroughly studied before dramatic moves toward market value accounting are made. In particular, the Federal Reserve is concerned that, without the development of standards for the estimation of market values, financial statements prepared on a market value accounting basis would not be reliable or verifiable by audits and examinations. The federal banking agencies are reviewing the use of market values in connection with the federal deposit insurance study mandated by the FIRREA. At the same time, the FASB is studying the need for greater use of market values in GAAP as part of a project to develop new comprehensive standards for all financial instruments. These studies should provide additional information regarding the appropriateness of market value accounting for purposes of bank regulation and financial reporting.

It is also important to emphasize that much can be done to reduce the differences between accounting and economic measures of financial condition and performance without adopting market value accounting. This is accomplished when declines in

economic value that result from credit problems are accurately reflected in loan loss reserves and capital positions in a timely manner.

Chairman Greenspan addressed the need to accurately measure capital positions in his testimony before this Committee on July 12, 1990, when he discussed his proposal for prompt corrective action. In this regard, a key part of this proposal is the conduct of on-site examinations — focusing on the quality of asset portfolios and off-balance sheet commitments — at least annually, where it is not already in practice. This rigorous review helps ensure that the loan loss reserves are consistent with the quality of the portfolio. When they are not, the examiner requires that additional reserves be created with an associated reduction in the earnings and equity capital of the bank. This process leads to a timely review of the adequacy of loan loss reserves and an accurate measurement of capital positions. When the resultant capital position of the bank is not adequate and credible capital raising commitments are not met, the regulatory agency should promptly require such responses as lowered dividends, slower asset growth, divestiture of affiliates, and other corrective measures while an institution's capital position is still positive. Such a policy not only deters banks from riskier lending practices, it also minimizes the ultimate resolution costs.

While the adjustment of recorded asset values for inherent credit losses could be accomplished through market or economic value accounting, it can also be accomplished under existing GAAP. Timely, thorough on-site examinations focusing on asset quality, together with rigorous application of GAAP, result in loan loss reserves that accurately reflect the estimated credit losses inherent in loan portfolios and in accurate reported capital positions. This process narrows differences between accounting and economic measures of depository institutions' financial condition and performance, while avoiding many of the potential problems associated with market value accounting. While not provided for in current GAAP, if further guidance were provided to determine an appropriate method for deriving the present value of asset and liability cash flows, even more accurate measures of market or economic value could be estimated.

THE IMPORTANCE OF CAPITAL STANDARDS

For a number of years, the Federal Reserve and the other banking agencies have been working to strengthen bank capital positions. The Federal Reserve has long viewed adequate capital as essential to protecting the soundness of individual banks and our banking system as a whole. While some have set forth arguments about the competitive disadvantages of stronger capital requirements, we must not ignore the long-term benefits of strong capital positions. Well-capitalized banks are the ones best positioned to be successful in the establishment of long-term relationships, to be the most attractive counterparties for a large number of financial transactions and guarantees, and to expand their business activities to meet new opportunities and changing circumstances. Indeed, many successful U.S. and foreign institutions would today meet substantially increased risk-based capital standards. In addition, although there has been uncertainty lately in the current market, the evidence of recent years suggests that U.S. banks have raised sizeable amounts of equity. The dollar volume of new stock issues by banking organizations has grown at a greater rate since the late 1970s than the total dollar volume of new issues of all domestic corporate firms.

I would like to elaborate on some of the important benefits that would result from stronger capital requirements. First, a stronger capital position would strengthen the incentives of bank owners and managers to evaluate more prudently the risks and benefits of portfolio choices because a substantial amount of their money would be at risk. In effect, the moral hazard risk of deposit insurance would be reduced. Second, stronger capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. For too many institutions, that buffer has been too low in recent years. The key to creating incentives to behave as the market would dictate, and at the same time creating these buffers or shock absorbers, is to require that those who would profit from an institution's success have the appropriate amount of their own capital at risk. Third, requiring stronger capital positions would

impose on bank managers an additional market test, in that they must convince investors that the expected returns justify the commitment of risk capital. Those banks unable to do so would not be able to receive the additional funds necessary for expansion. Fourth, strongly capitalized financial institutions are in a better position to take advantage of opportunities that may arise. Furthermore, it would not be necessary to apply as rigorous supervisory attention to such institutions. Thus, it is important that regulators make sure that financial institutions are operating not from a minimal capital base, but from a strong capital base.

The three federal bank regulatory agencies have a long established history of co-operation in setting minimum capital standards. Throughout most of the 1980s, the banking agencies required banks to meet minimum ratios of capital-to-total assets or leverage ratios. In 1989, the federal banking agencies also adopted a risk-based capital standard. Furthermore, the Federal Reserve System has adopted new leverage guidelines that will supplement the risk-based capital framework. However, the primary supervisory emphasis has shifted to the risk-based capital requirement. Prudent banking organizations would continue to operate with a cushion above the minimum leverage and risk-based capital ratios.

Risk-Based Capital

The risk-based capital framework adopted by all three of the federal bank supervisory agencies, in 1989, is based upon the international Capital Accord developed by the Basle Committee on Banking Supervision and endorsed by the central bank governors of the G-10 countries. Under this framework, total capital is comprised of Tier 1 (or equity capital) and Tier 2 (or supplemental) capital instruments. The risk-based capital standards establish for all commercial banking organizations a minimum ratio of total capital-to-risk-weighted assets of 7.25 percent for year-end 1990. This minimum standard increases to 8.0 percent as of year-end 1992. In addition to identical ratios, the risk-

based framework includes a common definition of regulatory capital as well as a uniform system of risk weights and categories.

The principal objectives of risk-based capital are to make regulatory capital requirements more sensitive to differences in risk profiles of banks, to factor off-balance sheet exposures more explicitly into the assessment of capital adequacy and minimize disincentives to holding liquid, low risk assets.

Leverage Ratio

The banking agencies are also engaged in implementing new minimum leverage ratios that will be based upon a definition of capital consistent with the Tier 1 capital definition that is used in the risk-based capital guidelines. The Federal Reserve has issued a new supplementary leverage standard which will require a minimum capital-to-assets ratio of 3.0 percent for the safest institutions. These minimum risk-based and leverage ratio requirements will enable us to remove the current capital-to-assets standards at year-end 1990. Similar leverage guidelines are being developed by the OCC and the FDIC, as explained in detail in the Federal Reserve's report to the Congress on capital and accounting standards used by the regulatory agencies.

The objective of the new leverage ratio is to ensure that banking organizations which hold substantial amounts of low credit risk assets must still maintain a minimum amount of capital. A financial institution operating at or near the established minimum level must have well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings, and, in general, be considered a strong banking organization. Institutions without these characteristics, including institutions with supervisory, financial or operational weaknesses, are expected to operate well above the minimum standard. Also, institutions experiencing or anticipating significant growth are expected to maintain above average capital ratios.

It should be stressed that the banking agencies have generally viewed their capital ratios as minimums. Furthermore, most banking organizations would wish to operate well above these levels. Over the years, the Federal Reserve has encouraged banks to continue to strengthen their capital positions. We have done this primarily through the bank examination process, and by requiring strong capital positions of those institutions undertaking expansion.

DIFFERENCES IN CAPITAL STANDARDS

As you are aware, we have submitted a report to this Committee detailing the capital and accounting standards used by the federal banking and thrift agencies. The differences in the capital standards of the banking agencies and the OTS are discussed in detail in our report. A summary of the primary areas of difference are presented in Table 2 of the appendix. The staffs of the banking agencies and the OTS meet regularly to identify and address differences in their capital standards and work toward consistency.

ASSESSMENT OF CAPITAL ADEQUACY

While current capital standards generally provide a cushion against losses from operations or a weak loan portfolio, they do not address all risks of an institution. For example, the bank risk-based capital guidelines, at present, do not yet address non-credit factors, such as interest rate risk and foreign exchange positions.

Interest rate risk is defined as the sensitivity of an institution's earnings and capital to changes in interest rates. This sensitivity may result from differences in the maturity or repricing of an institution's assets, liabilities, and off-balance sheet instruments. This type of mismatch occurs, for example, when an institution funds a long-term, fixed-rate loan with a short-term or variable rate deposit. When significant interest rate exposure exists, a relatively small adverse change in interest rates may result in a substantial reduction in an institution's earnings and capital.

11

Interest rate risk has been evaluated in connection with the overall determination of an organization's capital adequacy and financial condition during on-site examinations. Since a conclusive assessment of capital adequacy can be made only after consideration of all the quantitative factors that determine the need for capital, we think it is clear that the time has now come to place greater emphasis on the quantitative measurement of interest rate risk and to more explicitly factor interest rate risk into the assessment of capital adequacy.

To this end, the Federal Reserve is working with the other U.S. banking agencies and regulatory authorities on the Basle Supervisors' Committee to develop methods to measure and address interest rate and other non-credit risks. These methods are necessary to enhance the basic risk-based capital framework.

In considering how best to factor interest rate risk into capital adequacy calculations, we are guided by the following principles:

1. The system should provide incentives to reduce risk or a means to ensure that those risks which are assumed are backed by sufficient capital to fully protect the deposit insurance system and investors.
2. The system should assess the impact on the firm of interest rate volatility and hedging activities, including proper risk weighting of hedging instruments.
3. The system should be straightforward so that it can be widely understood and utilized by bank directors and management.
4. The system or the data required to implement it should not place excessive burdens or costs upon the institution.
5. The system should strengthen U.S. banking organizations so as to enhance their international competitiveness.

Although domestic and international work has been underway for some time, we have not yet achieved a consensus on how to measure interest rate risk or assess an appropriate capital requirement. However, it is necessary to find a measure that produces an acceptable interest rate risk measurement tool.

While the Board has not officially approved a particular approach to interest rate risk measurement, there are a number of possible approaches that the Board is likely to consider. One alternative might be to require all institutions, regardless of size, to provide detailed information on the maturity and repricing of their assets, liabilities, and off-balance sheet exposures. This information would then be used to calculate an institution's interest rate exposure and the corresponding capital requirement. One drawback, however, is that this approach could impose substantial reporting burdens on institutions with minimal interest rate risk.

Another alternative that the supervisory agencies might explore in order to deal with interest rate risk involves a two-phased approach. Under this approach, institutions would be screened by the use of a rather rough measure of interest rate risk, derived from minimally enhanced data that is, for the most part, already available in the Call Report. For institutions that undertake interest rate risks outside of established parameters, more detailed reporting would be required and could be the basis for a more precise calculation of an additional capital requirement.

We would certainly work to ensure that any approach that is finally adopted would be compatible with the interest rate risk measurement mechanism that might be developed internationally under the auspices of the Basle Supervisors' Committee. The approach that is finally adopted should be designed to afford regulators considerable comfort that institutions with undue interest rate risk have been appropriately identified, that a reasonable amount of additional capital for that added risk is being held, and that additional supervisory action could be taken as warranted. In addition, institutions that undertake interest rate risk outside of the established parameters would be expected to

have the management expertise, together with strong reporting and control systems that would enable them to undertake such risks on a knowledgeable basis. Moreover, the interest rate data that banks provide would be verified regularly through the examination process.

One area that must also be addressed involves the accounting treatment for off-balance sheet instruments. In order to better factor these instruments into the assessment of interest rate risk, more work will have to be done by the FASB to improve the accounting standards for these diverse instruments and provide more specific criteria for hedge accounting.

CONCLUSION

In summary, the Federal Reserve believes that both accounting and capital standards play an important role in the supervisory process. In addition to providing important information to market participants, accurate and timely financial reports enhance the supervisor's ability to monitor an institution's financial condition and take prompt corrective action.

Stronger capital positions and prompt corrective action by supervisors will help reduce excessive risk-taking by insured institutions. The requirement for depository institutions to maintain strong capital positions sufficient to cover on- and off-balance sheet risks will promote the safety and stability of our banking system and protect the interest of the U.S. taxpayers. The Federal Reserve will continue to work with the other supervisory agencies to develop uniform capital and accounting standards that achieve these important objectives.

Table 1

Summary of Differences in Reporting Standards

Resulting from differences in GAAP for banks and thrifts

- **Specific valuation allowances for, and charge-offs of, troubled real estate loans not in foreclosure** — The banking agencies require reduction of the value of a troubled real estate loan to the fair value of the underlying collateral, generally determined by a current appraisal. The OTS requires a reduction of the value of the troubled real estate loan to the estimated net realizable value (NRV) of the collateral, which may exceed its fair value.

- **General valuation allowances for troubled real estate loans** — The banking agencies require that the general valuation allowance be sufficient to cover estimated losses on all loans, including the remaining balances of troubled real estate loans that have been reduced to the value of the underlying collateral. Once troubled real estate loans have been reduced to the NRV of the collateral, the OTS does not require that general valuation allowances cover the additional risk of loss in these loans.

- **Valuation of foreclosed real estate** — The banking agencies require that foreclosed real estate be valued at the lower of book value or fair value on and after the date of foreclosure. After foreclosure, the OTS requires a valuation allowance for foreclosed real estate based on the NRV of the property and addresses the additional risk of loss through its risk-based capital standards.

Resulting from standards of the banking agencies that are intended to be more conservative than GAAP

- **Sales of assets with recourse** — With the exception of sales of pools of residential mortgages, the banking agencies generally require that assets sold with recourse be treated as financings (i.e., remain on the balance sheet). The OTS permits assets sold with recourse to be removed from the balance sheet in accordance with GAAP.

- **Futures contracts, forwards, and standby contracts** — The banking agencies generally require futures and forward contracts to be marked to market and standby contracts to be reported at the lower of cost or market. The OTS practice is to follow GAAP, which may result in loss deferral when futures and other contracts are used for hedging purposes.

- **Excess servicing fees** — With the exception of sales of pools of residential mortgages, the banking agencies do not permit excess servicing fees resulting from sales of assets to be recognized as upfront income. The OTS permits upfront recognition of excess servicing fees, as permitted by GAAP.

- **In-substance defeasance of debt** — The banking agencies do not permit banks to remove debt from their balance sheets by irrevocably dedicating risk-free assets to a trust for the debt's repayment. The OTS permits this in accordance with GAAP.

Table 2

Summary of Differences in Capital Standards

- **Leverage ratios** — The FRB and OCC have recently revised their standards to a minimum 3% Tier 1 capital-to-assets ratio (FRB requires an additional capital cushion depending on a bank's financial condition). The FDIC is in the process of coming up with a ratio similar to the FRB. As required by FIRREA, the OTS uses a 3% core capital (Tier 1) ratio and a 1.5% tangible capital ratio standard.

- **Goodwill** — All goodwill is deducted for purposes of calculating bank capital. The OTS does not require deduction of "qualifying supervisory goodwill" through year-end 1994.

- **Other intangibles** — The FRB and OCC generally require that intangibles exceeding 25% of Tier 1 capital be deducted when calculating capital ratios. The FDIC has proposed a similar rule. The OTS, on the other hand, applies this limit to intangibles other than purchased mortgage servicing rights.

- **Subordinated debt** — All bank regulatory agencies limit subordinated debt to 50% of Tier 2 capital. The OTS has no limitation in Tier 2.

- **Subsidiaries & associated companies** — For the OTS, subsidiaries engaged in permissible activities are consolidated if majority-owned or pro-rata consolidated if owned between 5 and 50%. Investments in subsidiaries engaged in impermissible activities are deducted.

  The banking agencies have the flexibility to require consolidation, pro-rata consolidation or deduction of subsidiaries and associated companies but generally require consolidation of subsidiaries that are majority-owned.

- **Mortgage-backed securities** — The OTS assigns privately-issued "high-quality" MBS (i.e., those with AA or higher investment ratings) to 20% risk-weight category. The banking agencies only assign to the 20% risk-weight privately-issued MBS that are collateralized by government agency or government-sponsored agency MBS.

- **Assets sold with recourse** — In general, the banking agencies and the OTS require a full capital charge against assets sold with recourse. However, in the case of limited recourse, the OTS limits the capital charge to the lesser of the amount of recourse or the actual amount of capital that would otherwise be required against that asset. The bank and thrift supervisory agencies are reviewing all issues relating to recourse arrangements through the FFIEC.

- **Phase-in requirements** — The banking agencies, consistent with the Basle Accord, have a two-year phase-in, ending in 1992. The OTS has different phase-in rules, also ending in 1992, although the capital effects are very similar.

- **Mutual funds** — The banking agencies assign investments in mutual fund shares to the highest risk-weight of the assets that fund is permitted to hold. The OTS assigns risk-weights based on the assets actually held by the fund.

The CHAIRMAN. Thank you very much.

I want to move to some questions here, but would you want to this as a time to make any other opening comments, Senator Bond?

Senator BOND. I will wait until the question period.

The CHAIRMAN. Very good.

Let me say to Chairman Seidman and Comptroller Clarke, I know we have until the end of the year to try to resolve this problem, and we are discussing it and hopefully closing into a common position here even today. I would like to see us get this matter settled.

I don't propose that we can settle it here right this minute in the room, but I would like to see it settled say within the next 30 days if possible for this reason, that the Congress will be in session through that length of time and then we'll be adjourning and we may or may not find ourselves with a postelection session.

But I would like to be able to see this matter settled. It's going to have to get settled in any case, and I think we ought to settle it sooner rather than later, and I would like to have the opportunity to have this committee know that it has been settled and on what basis.

So I would like to encourage that we try to set that as a goal.

Is that something you think is reasonable, Mr. Clarke?

Comptroller CLARKE. Mr. Chairman, on its face it certainly sounds reasonable, but, as I indicated before, I'm not sure that I understand what is so unsettled. The Fed has adopted a final regulation that says that there is a 3-percent minimum leverage ratio that operates in conjunction with the minimum risk-based guidelines. It is available only for the highest quality institutions, and other institutions will have to maintain both risk-based amounts and leverage ratio amounts higher than that.

We are going forward with a final rule that says that there is a risk-based minimum and a minimum leverage ratio that is 3-percent. That minimum leverage ratio is available only to banks that are of the highest quality. Banks that aren't will have to operate at higher levels.

And, as you heard Chairman Seidman say, the FDIC Board is going to consider very shortly a proposal that says that there is a minimum leverage ratio of 3-percent, as I understand it, which is available only for the highest quality banks and everybody else will have to meet a higher leverage ratio and a higher risk-based capital standards.

It seems to me, as I indicated earlier, that we are really not talking about a matter of any substance here. We have already adopted the rise-based guidelines, and we have already adopted the concept of a minimum leverage ratio even though that's not part of the international agreement. We are one of the only countries among the G–10 countries that has included a minimum leverage ratio in addition to the risk-based guidelines, but we all agree that that's important, and I don't think we should step away from that. But I do believe we are substantially in agreement.

The CHAIRMAN. Well, you know, it gets into semantics. We may be substantially in agreement, but if we're not in agreement and if we don't nail it down and capture it and finish it, then it's still up in the air, and I detect the fact that while we may have closed

down to what some might see as a small difference, I think we've got to eliminate the difference. I think we've got to get it settled.

The concern that I have, and it relates to something that Director Ryan said, and that is in the FIRREA bill where we toughened all these standards and we put all of these reforms in place and we keyed that off the national banking standards, we didn't think at the time that we might have any divergence with respect to the national banking standards, and we really can't afford to have that. I mean we've got enough problems over here anyway in the savings and loan system without having any playback of something that isn't completely clear.

So if we're that close, it seems to me then that taking another 30 days to get down to sort of a settlement shouldn't be that difficult.

What is your thought, Mr. Seidman?

Chairman SEIDMAN. Well, I agree with that, Mr. Chairman. Our proposal will be exactly the same as the Fed's. So there will be two of the agencies where there will be no differences if our Board adopts the proposal of our staff, which I believe it will, although I can't be sure obviously. So there will be no differences, and the only difference will whether the Comptroller wants to adopt the same language that is being adopted by the Fed and the FDIC or not.

Again, I say that we would have preferred to go to 4½ as opposed to 3, but in the spirit of compromise and so as not to let the number three disappear since there were such strong interests in it, we worked out this other way of handing it with the Fed.

As far as I'm concerned personally, I don't understand really why if we're so close together we just don't all adopt the same wording. We have two agencies that have agreed totally on the wording, or at least our agency and I and our staff agree on it.

It seems to me we ought to be able to proceed, but that is obviously up to the Comptroller. Since the Comptroller has your law in terms of the national bank standard being a standard, it seems to me it has to be settled one way or another. There is a lot more involved here than just a little tangle.

The CHAIRMAN. Well, that's what I want to get to because I'm hearing Comptroller Clarke saying that this is really a very modest difference and it has sort of an insignificant consequence, and I'm hearing you say something quite different. You're saying there is a difference, and in your mind, and I don't want to put words in your mouth, you think there is potentially a very significant consequence as to the difference.

Chairman SEIDMAN. We are running into that right now because, as I say in my testimony, when you're dealing with thousands of supervisors and thousands and thousands of banks, they need a clearly defined standard. If there are differences in wording between these two standards, you can believe that both supervisors and banks are going to want to know why it's there and what the problem is and what is the difference. We are already running into that in the sense that we are finding many cases where 3-percent is considered adequate because that's the minimum standard.

Now I haven't seen Comptroller Clarke's final wording, and it sounds like he in his wording has moved a long way. I think we

have to have exactly the same wording just the same as we have had in the past.

The CHAIRMAN. But just to settle this one issue, at least in my own mind, Comptroller Clarke feels that the differences right now are really quite small and of not great consequence one way or the other, and your view is that the differences, however small, if left outstanding and not settled are material and carry some considerable consequences.

Chairman SEIDMAN. In practice I think they can make a major difference.

Comptroller CLARKE. Mr. Chairman, if I may, what is in the rule is not the part that is of consequence because we are all embracing a 3-percent minimum leverage ratio and we are all embracing a risk-based minimum guideline. What is of consequence is how we implement those rules. As I said earlier, under the current guidelines, the 5½ percent primary capital, 6 percent total capital test that we are all phasing out at the end of the year, all of our agencies have had the discretion to require, and quite often have required, that banks operate above those minimum levels. We have not had formulas, and we have not had stipulated percentages that banks have to follow. We have used supervisory judgment, which I will tell you again I think is critically important to all of us being able to get our jobs done.

If somebody comes back and says, after our having adopted a minimum leverage ratio of 3 percent that any one of us is now allowing all the banks that we supervise to operate at 3 percent, then I would agree with Chairman Seidman that there is a substantive difference. But that's only the starting point, as it has been the starting point under our old guidelines. I would suggest to you that what is really important and what is really the substantive issue here is how we're going to operate in supervising banks above those minimums.

The CHAIRMAN. Let me just ask you one other thing, and then I'm going to yield to Senator Bond, and that is when you said, Comptroller Clarke, that you required capital above the minimum on a case-by-case basis, are you referring to capital directives and, if so, have you been issuing capital directives, any significant number of them and, if not, what steps do you take?

Comptroller CLARKE. The most frequent step we take is either to get the board of directors voluntarily to agree to increase capital or to take some enforcement action, such as a cease and desist order or a formal agreement, which mandates that they get their capital up to a specific level by a specified period of time. The capital directive is another tool that we have, but that is generally not one that we implement because it is so narrow.

The CHAIRMAN. Have there been many of those?

Comptroller CLARKE. Not very many because we usually get it done in other ways.

The CHAIRMAN. I see, but I mean how many, a dozen or half dozen?

Comptroller CLARKE. I can get the number for you.

The CHAIRMAN. I mean is it an insignificant number?

Comptroller CLARKE. It's a relatively small number because, as I say, we most often use our other burden enforcement techniques.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

I have listened with interest to the testimony. I know that Director Ryan and Governor Angell talked about interest rate risk, and that brings me back to sort of a home town question.

Since I come from Kansas City, Director Ryan, it may be of little surprise to you that the media back there has raised a number of questions about the Franklin Savings situation, and I know that the initial decision of the district judge has been stayed or temporarily withheld, but there has been a great deal of questions about the accounting and the evaluation of that situation.

I realize that you may be circumscribed in your ability to discuss a matter which is under litigation, but do you have some further thoughts or general principles which might be derived from the district court's findings and the situation as it exists in the Franklin Savings case?

Director RYAN. Senator Bond, as you've stated, I think I do have to be somewhat careful because this matter is now in fact pending before the tenth Circuit Court of Appeals. As you know, the district judge issued a ruling last week which turned the institution back to its shareholders. We asked for a stay of that decision from the judge. He denied that request, and we appealed on an emergency basis to the tenth circuit. They granted a temporary stay, and that stay could be made permanent or it could be lifted within the next few days or at least within the next 10 days.

I would like to make one comment. The ruling of the judge was as to a decision made by my predecessor, Chairman Wall, who made the initial determination, and I guess at that time he was Director Wall, to place Franklin into conservatorship.

As all of you will probably remember, and this takes you back 6 months to one of my first times before this committee, that was clearly an issue on the table, the constitutionality of the Chairman Wall appointment to Director, and part of the reason I know that the Chairman moved that hearing along very quickly, which we all appreciated, was the need for us to review these decisions.

So one of the first things I did was to review the decision made by Mr. Wall. I looked very closely at all of the relevant files. I in fact expanded my review and talked personally with at least three of the experts involved retained by the OTS. I also talked with managers of some of the accounts retained by the RTC.

I came to the very firm conclusion, which I have today, that that institution, Franklin, is appropriately in the RTC. That position will not change. I think it's an extraordinary risk for the FDIC, and I am very hopeful that when we have a full hearing before the tenth circuit, that the tenth circuit will reverse the district judge in Kansas.

Senator BOND. Any other comments on the interest base risk and the manner in which it was hedged?

[No response from the panel of witnesses.]

All right. Let me move on to another question. The risk based capital standards are being phased in and, as I understand it, they will apply a single capital requirement to all commercial lending,

but we know that all commercial loans are not alike in the degree of risk which they entail.

Do you think we should be pursuing efforts to get agreements to apply different capital standards to different categories or risk content of commercial loans?

Mr. Seidman or Mr. Clarke.

Chairman SEIDMAN. Well, I think that one of the great dangers of getting into risk based capital is that it can move toward getting a different risk weight for each kind of asset and it soon becomes so complicated that it almost collapses of some weight. Now the Fed had a system like that many years ago, and it finally got to be so difficult that they put it aside.

What that does illustrate, however, is that risk based capital as we have it today is a rough approximation. It's 50 percent for mortgages, home mortgages. Well, it is hard to know whether that is the right percentage or not, and there are other percentages along the way. All commercial loans are treated the same. Triple A's and triple D's are all treated the same. So it's a very rough approximation.

I think it's a useful step, and I'm pleased to have been part of putting it in place with the other agencies, but it is simply another measure.

Senator BOND. Do you want to comment on that, Mr. Clarke?

Comptroller CLARKE. Senator, I would agree with Chairman Seidman. This is something that was thought about at the time the risk-based guidelines were being developed, whether there should be differentiations made among different types of credit risk in the loan portfolio. The problem that you run into is where to carve it up, how many categories to have and so forth. We all recognize that there is a difference in risk between a triple A-rated corporate loan and a used car loan, but it's very difficult to figure out where to draw the line in between. So all loans were put in the 100-percent risk weight category, which means that they tend to balance each other.

One point that I don't want to let go unanswered is this issue that 10,000 banks in America can lower their capital as a result of the new capital standards that we're proposing. To an extent that is true with respect to risk-based capital in absolute dollar terms, but it is a misrepresentation of what is really going on.

When you compare the risk-based standard with the old standard that we're phasing out at the end of the year, you need to remember that the old primary capital standard included the loan loss reserve. A bank could technically meet its capital requirement and have nothing in its capital account except the loan loss reserve. I think we all agree that that doesn't make a lot of sense, and that has been changed under the risk-based guidelines.

It's also important to remember that under our current guidelines off-balance-sheet risk is not counted. All of the securitized assets and all of the recourse that may be off-balance-sheet do not have to have capital maintained against them under the current standards. Under the risk-based standards, those risks will all be brought onto the balance sheet, and capital will have to be maintained against them.

I don't want to let the opportunity pass without pointing out that it is misleading; it's comparing apples and oranges to say that the risk-based capital standards have the effect of lowering the capital for all of the banks in America because they simply do not do that. And banks under our old rules have not operated at the minimums. We haven't allowed them to operate at the minimums, and we are not going to allow them to do that for the most part under the new standards.

Senator BOND. I might just see if there are any other comments on that from Governor Angell.

Governor Angell. Senator Bond, I agree with the previous statements that risk-based capital can become too complex. Not only could it become too complex, but it could get regulators into the area of judgment, which is the expertise of the commercial banking and other financial institutions. That is, this assessment of the amount of risk going with each loan is the attribute that makes one banker more successful than another banker.

So when we talk about minimum standards, we're talking about minimum standards that have been designed to bring the entire world's commercial banking system somewhat into more alignment. The Federal Reserve's emphasis upon risk based capital was designed to recognize that we had some exposure in the payment system not only to the capital position of U.S. banks, but also the capital position of foreign banks. In the international compromise it appears as if some of the numbers are somewhat lower.

Now I would agree with Mr. Clarke that in the case of the risk-based capital some of our concern is that the risk-based capital standard itself may be somewhat on the minimum side. It's not just the 3-percent minimum leverage ratio, but the entire risk-based capital standard may not provide quite as much protection as we think is necessary for a banking system entering into a stress period. So our emphasis is upon capital increases.

Now if we could just wave a wand and have more capital in all these institutions, that would be a wonderful deal, but in a market-oriented system, franchise value has to go with the flowing of capital into these institutions. We have had to go easy in regard to getting what it is we want, which is more capital.

Everyone knows we need more capital cushion, but we have to be careful that we do not, in a sense, raise the standards in such a way that capital markets would react by saying we are not going to put any capital in those institutions. It's a very difficult period that we're in, and I think all of us here are dedicated to the proposition that we need more capital.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. Well, I think that's a pretty strongly felt and strongly put point and I think widely shared by members of this committee in terms of the urgency of getting the capital built up and how best to do that. I mean the franchise value, whether we've got a franchise that is capital worthy and capital attracting and can generate the earnings in the form of retained earnings and capital coming from that source is really a critical issue here.

Comptroller Clarke, I want to go through this one aspect of this a little bit further and then maybe we'll stop at a second round here and move on to Mr. Breeden.

Last year the GAO testified about your proposed 3 percent leverage ratio, and the GAO said, and I quote: "After reviewing the issues, we conclude that capital requirements should not be lowered for any banks in the process of converting to the risk based capital standards." That opinion was based on five items, and let me just tick them off.

No. 1, the lack of experience with risk-based standard.

No. 2, the increasingly competitive environment for banks.

No. 3, the banks should not be signaled that lower capital is acceptable.

No. 4, risk based standards do not cover risks other than credit risk.

No. 5, the FDIC's reserves are at historic lows.

Now with the GAO having expressed that view, now granted this was a time back, but it's directly on point here, how do we set those concerns aside here? It seems to me they are giving us a warning here.

And let me add one other thing to it. When you said earlier that you haven't issued very many directives, really very few capital directives, and that's because you work it out on a case-by-case basis I take it——

Comptroller CLARKE. Or you order it done otherwise than through a capital directive. A capital directive is a very narrow kind of remedy.

The CHAIRMAN. Here is my concern. I'm concerned about our ability to provide effective oversight as to what is going on and whether there are structural weaknesses out there and whether it's accumulating and posing a new level of risk to the system that we may not fully appreciate. You might see it and we might not be able to see it. We have an obligation to make sure that we're doing everything necessary to be sure that we do see it. We might attach a different value judgment to it than you might. So we've got to have a way to measure ourselves what is happening here.

I would be concerned, for example, if we had big banks that were really showing an eroded capital position and were not getting capital directives and things were being worked out some other way and we might not even know about that.

Comptroller CLARKE. Mr. Chairman——

The CHAIRMAN. And I don't say that in accusatory way.

Comptroller CLARKE. No, I understand. I do think it's important to make sure we're talking about the same thing. If you mean by capital directive the OCC as the supervisor telling a bank it has to get it's capital up, then we issue lots of capital directives. But, as you recall, the Congress gave the federal bank regulators a specific tool called a capital directive that is focused solely on capital. And if you are talking about that as a capital directive, then we issue relatively few of them because most of our enforcement actions cover things besides capital.

Virtually every cease and desist order that we issue and every formal agreement that we enter into with a troubled bank includes a requirement that that bank raise its capital. But they also include a whole bunch of other things, and that's what I meant by working it out differently. We direct banks to raise capital either by ordering them to raise it or by getting them to agree to raise it,

but we don't use the narrow remedy of the capital directive very often.

The CHAIRMAN. Well, I think the Congress would be inclined, and I can't speak for the whole Congress, but the capital directive approach is a pretty clean and direct way to do it, and it gives us a chance to keep track as to what exactly may be going on here.

Comptroller CLARKE. Mr. Chairman, we can tell you just as easily how many of our enforcement actions that we've taken included articles requiring increased capital. Whether we use the specific tool called a capital directive is really not of any consequence.

The CHAIRMAN. How many of those would there have been say in the last 6 months or 1 year, the informal directives?

Comptroller CLARKE. A lot, but I can't tell you exactly how many.

The CHAIRMAN. Hundreds, dozens, what's a lot?

Comptroller CLARKE. Dozens as of the first half of this year.

The CHAIRMAN. Major institutions?

Comptroller CLARKE. Major institutions, small institutions, medium sized institutions. When you read about a problem bank entering into a formal agreement with the Comptroller's Office, or even a memorandum of understanding, or having a cease and desist order imposed on it either by consent or involuntarily, I would say that almost all of the time that enforcement action requires, among other things, an increase in capital.

The CHAIRMAN. I guess the thing that is of concern to me, and we have had a lot of hearings here and different ones of you have been here on different aspects of this problem, namely, what is the condition of our banking and thrift system, how strong is it, what problems do we have with the insurance funds, is capital adequate, are we building it, is the franchise properly designed, all these things tie together.

The sense I have is that the insurance fund is just one bottom line that is under very severe stress and has been now for some time, and even with premium income coming in, the reserves are dropping.

I see a hollowing out of real estate values across the country. I mean it's happening region by region. Chairman Seidman has come in with his map which shows how that problem has been spreading. There are stories in the paper today about this particular region. There are very few regions that are exempt from it. So you've got this hollowing out of balance sheet values and outstanding loan commitment and so forth quite apart from what the justification may have been and looked like when loans were made some time in the past.

So we've got a kind of economic erosion occurring underneath the system, and it now raises the question of whether or not the capital cushions that remain are going to be adequate to protect us from overrunning the reserves that are still in the insurance fund, and I have a real concern about that.

Comptroller CLARKE. I do, too.

The CHAIRMAN. I think we are getting down to the point, and when I see a recommendation being made, and properly so, we talked about this just 3 or 4 weeks ago in here, to increase the in-

surance premiums being paid by banks into the insurance fund to the maximum under the law, and that is still leaving a question as to whether that will give us a net addition in reserves or that will just better cushion the rate at which the reserves are being drawn down, I'm not comfortable with the fact that we've got enough cushion left. I'm just not comfortable with it.

That's why I don't think we can fool around any longer in having outstanding issues on capital standards kicking around. I think they've got to be settled, and I think they've got to be settled because we've got to know what we're doing and there has got to be uniformity and everybody has to understand it.

If these things are that inconsequential, then they ought to be settled, and reasonable people ought to be able to sit down in a room and hammer it out and get clear signals out there to everybody so that everybody is marching to the same drummer. We've got enough problems over in the savings and loan system getting that situation stabilized that I don't think we can afford any fuzziness or ambiguity in what the standards are. I don't know how else to say it.

I don't know, Senator Bond, if you've got a feeling on this or not, but that's my feeling. So that's why when I said earlier that I thought we ought to hear some commitment to try to get this thing nailed down and 30 days, and 30 days is a long time, and especially when we've been at it for the better part of a year. I'm hearing still some differences of opinion here and I think they've got to be settled quite frankly.

Does anybody want to respond, or otherwise I'm going to move on to something else here.

Comptroller CLARKE. Mr. Chairman, at the risk of sounding like a broken record, I would just say one more time that where the minimum leverage ratio is set, given the fact that all of us recognize it is only the highest-quality, best-managed, least-risky banks that are going to be able to take advantage of it, is not the point. The point is the bigger one that you're making, whether for the other banks we are being diligent in requiring enough capital to protect the system and to protect the insurance fund.

No one has ever been able to come up with a magic formula that you can feed into a computer and that will tell you exactly how much capital a bank need to have. But I can assure you that, based on all of the flack that I have been taking over the last 6 months from bankers about criticisms of assets and insistence that they get their capital and reserves up, which under our new standards depletes their equity capital, we have made material progress in strengthening capital standards for the system. That's the point we need to be focusing on. As I said earlier, if you have a concern about whether in the course of our enforcement activities we are requiring banks that are undercapitalized to raise capital, we can provide you that information. You will find that we are.

The CHAIRMAN. Well, I would like to look at that. I think we need to see that.

Comptroller CLARKE. I would be glad to provide it.

The CHAIRMAN. Let me just ask you, Chairman Seidman, I mean you've heard me try to put into words my anxiety and uneasiness here, I would like to hear your response.

Chairman SEIDMAN. As I have said, Mr. Chairman, I think it's absolutely essential that we agree on capital standards, and not that we almost agree or my standard really means what it says, but I won't agree to it. I think that is no way to run a government. I don't think it makes any sense, and I've expressed that to Mr. Clarke many times.

We thought 4½ percent was a right number because that would ensure that 10,000 banks would not perceive that their minimum capital standard had been changed. In the spirit of compromise we said well, if you are in love with 3 percent we will go along with your amorous intentions toward 3 percent, but that's only for the finest suiters, camel one defined. There aren't any.

So it really was an exercise that I tell you I find very difficult to know what to say further. I don't think that under any circumstances we should indicate to 10,000 banks that their minimum capital standard has been reduced. Maybe they won't change their capital, but of all times under these circumstances to be talking about why we have to have 3 percent in there because 3 percent has this great balance which he at the same time says doesn't apply to anything because almost all banks aren't going to use it, I find it difficult.

I'm really a great compromiser and I've tried hard on this one. I mean we put 3 percent in. We worked with the Fed to put 3 percent in. We came up with everything we could to accommodate Mr. Clarke, and we haven't been able to do it. So I don't know what further I can say.

The CHAIRMAN. Before I go to Mr. Clarke, and I want to do that, Mr. Angell, can you shed any more light on this at this point?

Governor ANGELL. The Federal Reserve wishes to use our efforts to bring together some notions in regard to these unfortunately mentioned and highlighted numbers. We don't like the emphasis upon the 3 percent. That leverage ratio is only designed for institutions that have such high quality assets that the risk-based capital doesn't really catch them. So their leverage ratio would fall below the 3 percent.

And since the tier 1 risk-based capital standard for 1992 was 4 percent, we felt that we could go with a slightly lower number without giving any indication that we view that minimum as being the desired level of capital.

We believe that in this period of stress that many people have learned, including those who are stockholders and managers of banks, that it pays to have more capital, and regulatory surveillance certainly puts a bank in an undesirable attitude. So we want the capital to be brought up.

We believe that everyone knows now is the time to have more capital. Stockholders know it, the money market managers know it and everyone knows it. So we think that there is a consensus here that's in the making and we are moving forward.

The CHAIRMAN. If we were to go with the Fed proposal as it has now been put forward, what is the disadvantage with that and why can't we do that, Mr. Clarke? I mean what do we lose? I mean where is the harm if we go with that?

Comptroller CLARKE. You can do that, Mr. Chairman. There are a whole variety of things that you can do, and we have walked

through that analysis in some detail in our final rule. The one difference in the rule we are putting out and what the Fed has put out—and I maintain it's not a significant difference, but it is the only difference you can really tote up—is that we have not delimited the banks in terms of the camel one rating. Once again, it's somewhat theoretical, but possible, that you would have a one-rated bank that you would want to have raise more capital.

These are issues that I have discussed with Chairman Greenspan and Governor LaWare and others on the Supervision Regulation Committee at the Fed, and we finally just said in the overall scheme of things it doesn't make any difference. They'll put the camel one rating in, and we'll put the language in about the top-rated banks, the best banks, the best-managed banks, and we're really at the same point. I really am sorry that we are having to spend this much of the committee's time talking about something that is of not that much consequence.

The CHAIRMAN. Well, let me tell you, we've got a lot of other things to talk about, and if it were settled, we wouldn't be talking about it. But sitting here we are hearing differences of opinion that sound to me significant. Now they are not significant in your mind, but they are significant in his mind, and I sense that they are significant enough in his mind that he has come up with a proposal, he representing the Fed, that is different.

Comptroller CLARKE. The Fed is already out on the record.

The CHAIRMAN. Pardon?

Comptroller CLARKE. The Fed has already adopted their rule. Our rule is in the process of being cleared or it would be out. The only one that isn't done is the FDIC rule.

Chairman SEIDMAN. The FDIC staff has recommended that we adopt the Fed rule as proposed, and I expect that our Board will adopt that.

The CHAIRMAN. Well, what are the chances of my selling my idea that I would like to be able to have you fellows back for a cup of coffee in 30 days and find out that we have wrapped this thing up and everybody is singing this from the same sheet of music?

Comptroller CLARKE. Let's try.

The CHAIRMAN. Well, that's a start. Let's see if we can't get it done. Let's just see if we can. We've got enough other things to worry about to have this thing hang out there any longer.

Senator Bond.

Senator BOND. Mr. Chairman, having had a little experience in running at government at a much lower level, I believe that one of the things that is absolutely imperative when you have a regulatory function or functions exercised by government is to enable the people who are regulated and those who are administering the regulations to have some degree of certainty as to what the rules are, and if you can't agree on a rule, then you're not performing your function.

For some reason it comes back to me that Chairman Gonzalez said about a week ago that he felt it was time that we had one regulator for financial institutions and have one basis for issuing these rules and regulations.

Now I'm very much impressed by the caliber of the testimony, and I think it represents the great deal of talent that the Federal

Government has attracted in the financial institution regulatory area, but I would have to say that if we come back 30 days from now and we still can't tell the industry that these people are supposed to regulate what they've got to do, that I may be joining sides with Chairman Gonzalez so we can at least get some answers.

But perhaps I'm missing something and maybe our distinguished witnesses here would have some views on why the trifurcated or quadfurcated system that we have now makes sense.

Would somebody like to enlighten me?

Chairman SEIDMAN. Well, I would say that this disagreement is the strongest argument I've seen in a long time for Chairman Gonzalez's point of view.

Senator BOND. Does anybody else care to step up to the plate? It's a slow fast fat one, if you want to take a cut at it.

Comptroller CLARKE. I think we've talked about this as much as it needs to be talked about.

Senator BOND. All right.

Let me pursue something else that we have talked about today. We have talked about the very important issue of accounting standards and figuring out when an institution is in trouble. Implementing the remedies that are available is also very important.

Director Ryan pointed out that FIRREA gave OTS the authority for early closing, and if I'm not mistaken, Chairman Greenspan when he was here about 1 month ago said that the most important thing you could do is to close down troubled institutions while there was still some value in them so it would minimize the exposure of the insured deposit fund, and I would be interested in hearing from Mr. Seidman and Mr. Clarke whether they feel there is adequate legislative authority for such early closures and, if not, do we need additional legislative authority? Are you contemplating any changes in procedures or do you see early closure as being a more important remedy in the future than it has been in the past?

Comptroller CLARKE. Senator, I would be glad to respond to that since as a primary supervisor we're in the role of the one that actually does the closing at least of a nationally chartered bank.

As I indicated in my opening statement, I think one of the most significant things that we've done within recent times is change our definition of insolvency to say that instead of closing a bank when it is primary capital insolvent, that we will close the bank when it becomes equity insolvent, which means that at that point the loan loss reserve has been taken out of equity, and if there is no more equity, then the bank is closed and turned over to the FDIC as the liquidator with the loan loss reserve in tact.

We don't have enough history yet to tell exactly what difference that has made, but there have been some instances where the losses estimated to be incurred by the FDIC fund in liquidating the banks that have been closed on that basis are expected to be materially less than they would have been had the bank been left open until its primary capital was exhausted.

I think the concept makes a lot of sense. The place that you get into a little bit of trouble involves the taking of private property. If there still is value there, if there still is equity capital in the bank, it becomes a little bit more troublesome to step in and say irrespec-

tive of that we are going to take away from the stockholders. It's an easy call when their interest in the bank is no longer present.

Senator BOND. My question is is that too late?

Chairman SEIDMAN. Well, if I could say so, Mr. Bond, our look at it is somewhat different, and that is we can't close the institution, but we can withdraw insurance. We asked to have the power to do that in a very short period of time in FIRREA. There was great opposition to that, and it came out as a compromise which improved our ability to withdraw insurance rapidly. However it still clearly cannot be done as quickly as we think would be beneficial to the system.

If the Congress were to revisit that issue, we'll be glad to remake the arguments that we made before that we need to have that power and be able to exercise it in a very short time.

On the other hand, I would just like to have the record show that closing an institution rapidly does not necessarily mean that we'll end up without loss. What we have learned is that when we close an institution we lose value per se by closing it.

Second, if the institution is not badly managed, we simply transfer bad assets from the institution to the Government or to the Government's responsibility and the losses continue until those assets can actually be redisposed into the private sector.

Once there is a built in loss because there are nonperforming assets, until those have run their course, that loss is built into the system.

I think Congress may well have to take a look at that issue. I have discussed it with Mr. Ryan in some depth, as to whether or not it is useful to close institutions which are undercapitalized but are not badly managed in order to cut losses. I mean I don't think it has been proven that that necessarily is the result, and we certainly have learned from our experience that once you close an institution you lose going value and that assets become worth less than they were the day before when they were in a going institution. So it's a very complex question and I just wanted to get on the record that it isn't just a simple answer, close them down and you'll stop the losses.

Senator BOND. Mr. Chairman, I wonder if we could hear any further responses from Governor Angell or Director Ryan?

The CHAIRMAN. Sure. Yes, by all means.

Governor ANGELL. Senator Bond, I think what Chairman Seidman has just said is so important. The economic going concern value may be quite different from the liquidation value. So the notion that the going concern value has equity capital that's positive and that you then place the institution under the trauma of, in a sense, a closing, then under those circumstances you may find that the gap between the going concern value and liquidation value can cause some exposure to the insurance fund. That is why it is so important that the owners' equity in the institution be maintained at a level that the owner will engage in the corrective action which is in the best interest of the stockholders and thereby best protects the insurance fund.

Director RYAN. Senator Bond, as you know because obviously you have looked at our written statement, we are in the process of fi-

nalizing an early intervention regulation right now which probably will be submitted to Treasury within the next month.

We find it not only important in the context of identification and early intervention, but also an important link to a program initiated by Chairman Seidman, which is the accelerated resolution process, which we hope will help to avoid some of the devaluation that has taken place within the conservatorship.

As I think you know, we are now about 35 or 40 days into a pilot project, and sometime I'm sure within the next couple of months the Chairman will be in a position to present some findings as to that pilot project.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. If I can continue on, I think this is a very important line of questioning and it sort of takes us over into a somewhat adjacent and different subject, but if I hear what I think you're saying, and this gets into semantics, but one of the words that has been used for a strategy like that is called forbearance. In other words, you may have a situation where you're better off to go in and forbear for a while to work it along because if you don't, if you just drop the hammer, you may crash the values down from where they are to a lower level and end up taking more money out of the pockets of taxpayers who have to cover the losses.

Now with a history during the 1980s, you know, any notion of forbearance tends to be sort of automatically seen as unattractive and not facing up to problems and such as that.

But what I'm also hearing you say now that you've had experience in shutting down a vast number of institutions that you may not be getting to a tier of cases where the judgment call may in fact look like it's one way, but if you track all the economics through you might find out that you're better off structuring some kind of a workout situation so that you don't end up causing a catastrophic loss in additional value that Governor Angell is talking about, and that maybe you can actually end up spending less money going that route.

Is that part of what I think I'm hearing you say?

Chairman SEIDMAN. I think we have to be talking about something except forbearance. So what we need is a new title for the discussion of this subject.

The CHAIRMAN. A new word.

Chairman SEIDMAN. Of course FIRREA itself has a plan for, if you will, deferral of closing based on acceptable business plans.

The CHAIRMAN. Right, exactly. We spent a long time working that out.

Chairman SEIDMAN. We had a similar thing for agricultural banks. It did not apply, however, to insolvent institutions. It applied to institutions that were below minimum standards, but not insolvent.

The CHAIRMAN. Right.

Chairman SEIDMAN. I think that's an important difference. When you get into those that are solvent, but are below standards, then I think you get into a judgment area. Given the size of the S&L problem, which is vastly larger than any of us knew, it may be that we diagnosed this as a golf ball sized cancer, and now it's a basketball and it may not be that the remedy is exactly the same.

I think it's a subject worthy of study, and we have been discussing that in depth with Director Ryan. There are certain things that we think require further study, and the accelerated program moves in that direction.

I think to every extent we can avoid forcing more real estate onto private sector markets right at this time, the better off the taxpayer will be in the total cost of this.

The CHAIRMAN. Well, you know, it looks that way from what just one reads in the tremendous flow of news accounts. This very significant drop in real estate values, residential values and commercial values pretty much across the country has added a whole new dimension to this problem because you have in effect a kind of workout situation. Now if somebody is clearly insolvent, that's one thing, but that tier that perhaps could make it on through and not become a burden to the taxpayer falls into a different category.

But it sounds like we now have these new economic conditions bearing in on this, and what I hear you both saying with carefully chosen words is that maybe there is some way here that ought to be looked at that can reduce these ultimate losses to taxpayers. I mean that's what I hear you saying.

Now I don't know how we capture that problem fast enough to be able to wisely and prudently consider doing something like that, but I can tell you that around here, and I'm sure Senator Bond would agree with your statement, Chairman Seidman, that the scale of losses is going beyond what anybody imagined. You make that point that even from your own point of view it exceeds anything that we anticipated.

Chairman SEIDMAN. Well, it's continuing to increase because every time we estimate losses now we're looking at lower real estate markets which means that the losses are higher.

The CHAIRMAN. Well, we'll meet at any time to sit down in a setting like this to hear any recommendations or proposals anybody wants to make. I don't think we're equipped to initiate those from a cold start. I think we would need to have really a professional view from yourselves as to what adjustments might be needed that can reduce losses, and if you have that kind of a proposal, I would also want to have the administration's viewpoint on that and would assume that that would be something they would be very much interested in as well.

Chairman SEIDMAN. Well, we have suggested this, Mr. Chairman, as a subject for study to the Treasury, and we are doing some work in that regard now and we are looking for what we think could be recommended and a new title for it. And as soon as we come up with that, we will be back to talk with all the parties involved.

Senator BOND. Mr. Chairman, I wish he hadn't extended that invitation because I had decided to resist the temptation to suggest that this deferred regulatory intervention program or DRIP—[laugher]—be initiated to avoid the flood of properties on the market. I was almost won over, but my better judgment was overwhelmed by that invitation. But I think what Mr. Seidman has suggested is that while early intervention in closure generally may be a good rule, and there is not a situation like we have today with the tremendous burden of real estate overhang on the market and a real question about the adequacy of the funds available for early

closure, then there is a very difficult and tricky regulatory path to follow. And if you follow it well, nobody will notice, and if you don't, you'll know that we will criticize you very severely for not having steered the right course, but we do wish you well.

Chairman SEIDMAN. Thank you, Senator, and we'll need all your good wishes.

I just want to bring out that we are talking here about carefully supervised management, and whether it is in one of these institutions or in the RTC, may be something that can be evaluated to see which kind of carefully supervised management might produce the best result in terms of cost for the taxpayers.

The CHAIRMAN. Well, I want to add one other thing for the record because there is a second-level cost here that's a little harder to see, and that is the more we pour assets into the RTC, the real estate assets commercial or residential or whatever they happen to be. I mean here we sit as taxpayers now with this great big collection of repossessed assets, and the more that come flooding in there, in a sense the lower the value tends to go for all the assets, and now those asset values are our asset values as the general public.

So in a sense we don't want to devalue our own assets any more than we have to. I mean we're talking here about some kind of a more orderly liquidation process or a leveling out process it seems to me because in the end what we want is value back. We are trying to retain value and retrieve value.

I think as Senator Bond says, it's a very, very difficult task, and I think you almost have to start by saying there is no good answer. The question is what is the best of a poor set of answers, and we don't want to inadvertently take the worst of a poor set of answers and end up driving up the cost without thinking through the relationship of all these things one to the other.

So I think you're hearing a bipartisan interest in wanting to listen carefully to any thoughtful proposal that the regulators feel is appropriate to consider or that the administration would feel is appropriate to consider, and we want to help you get your job done.

Thank you very much.

Let me now invite Chairman Breeden to join us.

The committee will come back to order, and let me give a special welcome to Chairman Breeden. We are delighted to have you with us today.

We have been underway about 2 hours, and we thought that we might get to you a little sooner this morning, but we especially want to hear your views.

We will make your full statement a part of the record, and I want you to go to the summary points that you think are most important for us to hear, and also I know you were able to listen to some part of that previous discussion, and anything that warrants comment on your part from that discussion, I would invite that as well.

Clearly the Securities and Exchange Commission plays an important role in ensuring that full and accurate disclosure is made by companies that issues securities into the hands of the investing public.

Many people question the value of today's accounting standards based on historical cost rather than market values. And this issue, as we have just been hearing, is critical for banks and for thrifts and for other institutions that deal in financial instruments, and particularly when we have the taxpayer at risk in terms of an insured deposit system that is the foundation of the way our entire financial structure is based in the world of banking.

So we very much look forward to your remarks at this time, and we would be pleased to hear from you now.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Chairman BREEDEN. Thank you, Mr. Chairman.

It's a pleasure to be here, and I did enjoy having the opportunity to listen to the earlier discussion which I think covered a number of very important points.

I am pleased to be here this morning to discuss accounting principles utilized by financial institutions, and I certainly hope to respond to the committee's inquiry on this most important subject in several important areas.

First, I would like to touch briefly on the role played by accounting principles in the growth and ultimate collapse of the thrift industry.

Second, I would like to review how certain of the specific regulatory accounting principles, or RAP accounting, and inappropriate or unique interpretations of General Accepted Accounting Principles, or GAAP accounting, adopted by thrift regulators facilitated the distortion of capital levels and the dramatic growth of the thrifts.

And, finally, I would like to discuss the extremely significant issue that the committee has raised regarding market-based accounting and its bearing on the proper role of financial accounting for financial institutions.

This committee has reviewed the history of the disastrous problems of the thrift industry. As you know, the thrift industry at one time was largely composed of small mutual institutions that were essentially incapable of rapid growth.

The enormous expansion of deposit insurance in 1980, coupled with the removal of interest rate limitations between 1978 and 1982, changed the basic characteristics of the thrift system in terms of the industry's ability to raise deposits to fuel a dramatic expansion of lending and investment. What had been a horse and buggy was replaced by a jet with after-burners.

Appropriate capital requirements were one potential source of discipline. They would have served both to assure that thrift owners risked some of their own money in the loans they made and to provide a cushion against losses. More importantly, a meaningful capital standard would have served as a check against uncontrolled growth by individual firms and by the industry as a whole. Instead, the thrift industry was permitted to engage in unchecked expansion.

Starting in the 1970's and continuing into the mid-1980's, Federal thrift regulators consistently acted in a manner that eroded and re-

duced effective capital requirements. In November 1980, for example, the Federal Home Loan Bank Board lowered the minimum net worth and reserve requirements that thrift institutions were required to satisfy from 5 percent to 4 percent. It further lowered that requirement to only 3 percent in January 1982. Thus, at the same time that the thrifts obtained vast new abilities to raise deposits, the Federal Home Loan Bank Board acted to increase permissible industry leverage from 20 to 1 to over 33 to 1.

In practice, the discipline that might have been provided by even a 3 percent capital requirement was significantly eroded by two other policies then in place. These were known as the 5-year capital averaging and 20-year phase-in provisions. Whatever their original rationale, these provisions helped lead to disastrous results.

Five-year averaging permitted thrifts to base the calculation of their minimum net worth and reserve requirements on average liabilities and deposits over a 5-year period, rather than on the current year's liabilities and deposits. This method of computation drastically lowered the capital requirements for those thrifts that were expanding most aggressively.

For example, under 5-year averaging, if a thrift with liabilities of $100 million in deposits took in an additional $100 million in deposits in the year 1983, or a 100 percent growth in a single year, it would have been required by virtue of the averaging to have only $1.16 million in additional capital rather than the $3 million it would have been required to have if it were not for averaging, and the $5 to $6 million that it would have been required to have had it been a bank.

If the thrift decided that that result was too good to be true and decided to take in an extra $1 billion in deposits rather than growing by only on a 100 percent—and a 1,000 percent growth at that period of time was not unheard of in the industry—it needed only $9 million in capital in order to support an increase of $1 billion in deposits and new loans. That is compared with the $50 to $60 million in capital that would have been required for a bank to take $1 billion in new deposits.

In addition, the thrift could lend out that $1 billion, and, because of the permitted booking of loan origination fees, was allowed to take 2½ points immediately into income when it lent out those loans—irrespective of how risky the loans were.

The CHAIRMAN. And even though the loans in the future might go totally down the drain at the front end, they would book the front end profit.

Chairman BREEDEN. Absolutely, irrespective of risk. So, for $9 million you could go out and get $1 billion, lend it out to anyone and book immediately a $25 million profit. That was a treatment that was found most attractive by a number of institutions. It was made possible by the combination of the averaging rule, low capital levels to start with, and the ability to book up front origination fees and take them immediately into income irrespective of the possibility that the loan would ever be repaid.

The 20-year phase-in provision also had an impact on the effective capital levels required for thrifts. This impact was most dramatic for newly chartered thrifts. Under the 20-year provision, a

newly chartered thrift had 20 years to inch its way up to the full capital requirement, whatever that requirement might be, such as the 3 percent rule.

So, in year one a newly chartered thrift had to have only 1/20th of the 3 percent capital that it was ultimately required to have. When you work through the requirements, the new thrifts were able to have a leverage ratio as high as 666 to 1 when they were created. Over a 20-year period they would get themselves down to a mere 33 to 1 leverage that other thrifts were permitted. We have some charts at the back of the testimony that try to depict graphically the hyperleverage that was utilized.

The outright reduction of capital requirements, when combined with the use of overly permissive accounting practices, permitted thrifts that were teetering on a shrinking or nonexistent capital base to engage in high velocity expansion. Indeed, from year-end 1980 to year-end 1985, aggregate thrift assets grew by almost $½ trillion, from $621 billion to over $1 trillion.

During the same period, RAP accounting permitted capital to be shown as increasing by about 45 percent. However, aggregate industry tangible capital fell from $32 billion to only $8.7 billion. So, while RAP accounting made capital look like it was rising, in fact it was plummeting. In only 5 years taxpayer contingent risks grew more than 72 percent while tangible capital fell about 75 percent. With virtually no capital at risk, the operators of some of these thrifts had nothing to lose and everything to gain. The availability of deposit insurance was, of course, critical to the ability of these insolvent institutions to continue to attract funds.

Whether financial regulators should have permitted the continued operation of troubled thrift institutions—the forbearance issue that you were raising with the earlier panel—is a separate question from whether regulators, irrespective of any forbearance policy, should have fostered accounting principles that had the effect of creating the appearance of net worth rather than the reality of that net worth.

If a decision is made to forbear from closing institutions due to an expectation that changes in the economy or other factors will permit their recovery, that decision should at least be made openly.

The CHAIRMAN. I might just say, and I don't want to interrupt the flow of your testimony because I think it's excellent, but we even saw the development of net worth certificates during that period of time as part of exactly what you're describing.

Chairman BREEDEN. Conceptually, the net worth certificates are a better approach, it seems to me, in the sense that it would be better to acknowledge the insolvency of an institution and then say what policy should be in effect during the period of time that we're deciding how to work out that problem institution. If it requires a certificate to bridge the negative net worth, better a certificate that has to be recorded every year so that Congress and the public know how big that gap is rather than cooking the books in a way that makes it look like there is net worth when in fact that net worth doesn't exist.

The CHAIRMAN. Right.

Chairman BREEDEN. Now, of course, if the certificates themselves are allowed to be used as a basis for growth, that would be another

matter; but certainly recognizing the size of the problem rather than its depth would, I think, have been a much superior approach.

Instead of that approach, accounting principles were modified in a way that allowed the insolvent institutions to appear to have positive net worth, thereby creating in effect a stealth balance sheet. By creating an accounting facade that was like a Hollywood movie set—the front of the building and perhaps some sides, but nothing else—net worth suddenly appeared out of what was in reality a sea of insolvency.

The committee's letter of request invited us to discuss the differences between RAP and GAAP accounting principles and also whether the thrift problems resulted from inappropriate accounting standards or from a lack of enforcement. These two issues are related aspects of the problems created by modifying accounting standards to create the appearance of solvency among institutions that, in economic fact, were not solvent.

Sadly, unlike the fabled emperor's new clothes of children's stories, the thrift accounting standards did conceal the underlying reality from many observers. Indeed, the appearance of earnings and solvency was used to justify not only expansion, but also dividends, enormous salaries, acquisitions, opulent and, indeed, at times repulsive corporate life styles and many other expenditures that drained cash from failing firms.

The most legitimate justification for the use of RAP is to require more conservative reporting of earnings or net worth by a regulated firm than GAAP might be interpreted to permit. However, the actions of the Federal Home Loan Bank Board relating to RAP during the period we are reviewing were designed to permit the firms overseen by the Bank Board to report an inflated net worth compared to that permitted by GAAP.

During the 1980's thrift RAP were significantly more liberal than generally accepted accounting principles. For example, thrifts were permitted by RAP to employ accounting techniques whereby they could utilize what was known as appraised equity capital, which was nothing more than selectively writing up the value of certain assets that the thrift may have owned, such as buildings. And while my testimony later will indicate a strong general preference in favor of using the market value of assets, the difficulty here was the ability of thrifts to pick and choose those assets that would be revalued on the basis of market value. Only the gainers were marked up and not the losers.

Second, as we already mentioned, under RAP loan origination fees could be immediately recorded into income, whereas fee income under GAAP would be spread over the life of the loan. If the loan was not repaid, the remaining origination fees would not be includable in income.

Third, RAP permitted losses on assets sold to be included in net worth as an asset, subject only to amortization over the contract life of the assets. This was an enormously significant policy and one, I think, that is dramatic in the degree to which accounting principles diverged from economic reality. Suppose you had a portfolio of $500 million in loans and it had declined in value and was sold for only $350 million, resulting in a loss of $150 million. GAAP accounting would say that, when you sold the loans, that $150 mil-

lion loss has to be recognized. Instead, under RAP as practiced in the thrift industry, the $150 million of loss was allowed to have the word "asset" hung over it and was put on the asset side of the balance sheet. Thus, the thrift was able to report that it continued to have $500 million in assets—in this case, the $350 million cash from the sale and $150 million of deferred loss.

The treatment of the accumulated losses as assets which could support loans on the balance sheet is a very curious idea, one that was so curious as to be extraordinarily popular. Indeed, through 1985, when the practice finally came to an end, $6.3 billion of accumulated losses got treated as capital. That was enough to support $209.7 billion in new loans backed solely and completely by accumulated prior losses.

The CHAIRMAN. But let me just stop you right there because I think to the citizen sort of trying to make sense out of this or looking in on it, how could something like that happen? How did that happen? I mean just what you've said so far, just the pile up of those kinds of accounting treatments, what drove that?

Chairman BREEDEN. Well, I think the supervisory authorities were concerned about the fact that institutions had low yielding assets on their books. At a time when their cost of funds might have been 8 percent, let's say, their loan portfolio might be yielding only 6 percent.

The CHAIRMAN. Now may I stop you again just for a minute here because I really want to get this and I want to make sure the record covers this. And part of that, was it not, due to the fact that we had had this enormous increase in interest rates and you had a lot of the traditional thrifts with these fixed rate mortgages at a much lower interest rate. So when interest rate ceilings went off, which you mentioned, and the fact that interest rates themselves during the early 1980's went up to very high levels, you had a situation where you had probably a nominal failure in a lot of these institutions because they had lent long at a low interest rate and they were now having to get deposits at a new high interest rate. Was that the principal cause or not, in your view, at that stage? I mean I don't try to say at all that there was a single cause, but what would have given rise to that burst of phony or creative accounting that you've been describing?

Chairman BREEDEN. Well, you're correct. Going back in history, the thrifts had traditionally been restricted to essentially one product, the mortgage loan, and that had traditionally been made on a fixed interest basis. In fact, throughout the late 1970's, policy at the Home Loan Bank Board was to discourage very strongly and, in fact, not to authorize the making of adjustable rate mortgages, even by those institutions who saw the interest rate mismatch coming.

So, you had an entire industry that, because of the inadequate diversification of its asset portfolio and because of its dependence on the fixed rate mortgage, was essentially making a giant interest rate gamble. And, in the late 1970's when interest rates skyrocketed, many of the thrift institutions were rendered insolvent, on a mark-to-market basis.

The CHAIRMAN. Right.

Chairman BREEDEN. They were not insolvent on the basis of the carrying value or the historic cost of those mortgages, or their face value. But if you looked at their true market value, those institutions were insolvent. In fact, in a very good study of this problem done by Professor Ed Kane out at Ohio State, he reflects, and it is cited in our testimony, that in his estimates by 1978 on a mark-to-market basis, the industry probably had an aggregate negative net worth ranging from $35 billion to $50 billion, and that by 1980 that had probably grown to between $78 billion and $120 billion in losses. So that situation occurred.

The CHAIRMAN. Before you go any further, because you have just said something that is very important, and I don't think 1/20th of 1 percent of the public or anybody else that even pays attention to this issue understands what you have just said or knows that to be the fact.

What you have just said is that the S&L industry was insolvent and had overrun its insurance fund back in 1978, between 1978 and 1980, but for a variety of reasons, some of which you have just recounted in detail, all of the creative and phony accounting and so forth, it was not until 1989 that that issue was put on the table, as you and I are as familiar with as anybody because we both were involved in writing the reform bill and drafting and getting it done, but the cold fact of the matter is that a decade earlier, a full decade earlier the industry had gone into the tank.

I'm not sure that was generally understood even at that time. I mean it's a lot easier to do these reconstructions after the fact than at the time.

But as you sit here now professionally, I mean isn't it a fact that the industry was insolvent in 1978 and 1979 and 1980?

Chairman BREEDEN. Yes. I think all of the studies of the thrifts and their portfolios, looking at the value of those portfolios at then market rates of interest, would have to conclude that thrifts were insolvent on an industry aggregate basis. Now, there were some thrifts whose portfolios were matched and didn't have this problem, but on an industrywide basis the thrifts became insolvent sometime probably in the mid-1970's.

Indeed, I recall that the Hunt Commission that was impaneled by President Nixon and issued its report back in the early 1970's, 1972 I believe it was, said that one of the most important problems facing the Nation's financial system was the crisis in the thrift industry. So this was certainly a problem that was brewing throughout the 1970's.

The CHAIRMAN. The Hunt Commission said that in 1972, and we didn't get the reform legislation that really dealt with all these problems in place until 1989. Boy, that's not much of a favorable commentary on the speed with which government works, is it?

Chairman BREEDEN. Probably not in general, although the Hunt Commission, when it said that, was talking about a range of problems, including inadequate asset authority, inability to pay above the regulation Q ceilings and a range of factors——

The CHAIRMAN. Yes, but we did all those things.

Chairman BREEDEN [continuing]. Which were addressed.

The CHAIRMAN. All those things came along in the 1980's, and instead of solving the problem, as you yourself have just testified,

because of these other factors that were at work, made it worse. I mean there was the deregulation and we opened it up and we got rid of regulation Q, and then we came along because we had an embedded financial problem of enormous consequence already, and we used phony accounting and a lot of other things to hope that over a period of years there would be a workout and that in fact the industry could get out of the hole, and in fact it dug a much bigger hole for itself. Isn't that basically what happened?

Chairman BREEDEN. Well, I think there was a sustained period of time in which the industry and its regulators continued to think that prayer and good thinking——

The CHAIRMAN. Forbearance.

Chairman BREEDEN [continuing]. And forbearance would ultimately some day——

The CHAIRMAN. RAP accounting.

Chairman BREEDEN [continuing]. That some day the tide would subside and that things would get better and, unfortunately, things got worse.

I do want to make one thing clear regarding accounting principles that were, shall we say, inappropriate interpretations of GAAP versus the RAP principles that some would characterize as phony accounting. With respect to the absence of mark-to-market accounting in the late 1970's: The difference between the minus $120 billion that Professor Kane says the industry's net worth was in 1980, and the positive $32 billion that the Home Loan Bank Board statistics said that it was in 1980, was not phony accounting because it was based on the difference between mark-to-market accounting and historic cost accounting. GAAP accounting permitted those institutions to reflect their mortgage portfolio on the basis of face value and cost rather than on the basis of market value.

So, in that respect, what concealed the disastrous problems in the thrift industries in the 1970's was not manipulation of GAAP per se, but rather the unwillingness to recognize actual current economic value. This was exacerbated when new industry tools, including the freedom to bid for deposits with unlimited interest rates and asset diversification, came along at a time when a great many of these institutions were already insolvent.

So, I think the problem was not necessarily that it's wrong to allow flexibility in the interest rates that are paid, and certainly the problem isn't that it's wrong to allow diversification in assets. That generally reduces risk rather than increases it. Rather, the problem is that, when some of those things are being done by firms that are already insolvent, then you can experience very great distortions in the results that will occur. And, sadly, that was the fact. The institutions themselves knew that they were insolvent because managers of financial firms, at least those that are even mildly competent, know what their own current market value is, irrespective of what the accountants required to be carried on the books. If it's substantially below zero, if they are in effect insolvent, then they have every incentive to take big risks in the hopes that they will recoup those losses.

It's really the old "heads I win, tails you lose." I can take in new deposits, make loans at much higher risk, and, if those prove to be successful, the benefits will accrue to the institution and it may

claw its way out of insolvency. If there are losses, well, that's the problem of the insurance fund since the institution will have had no real equity on a net basis at stake at any point.

But it is a combination of the distortion, the enormous distortion, in a fluctuating interest rate environment coupled then with specific steps that the Bank Board took, such as deferring the recognition of loss, that was a divergence from GAAP. So you had both items.

The CHAIRMAN. Well, let me just ask you something else at this point. Now to a citizen sitting out there today who is trying to make sense out of all of this and trying to make sense out of what has happened in the last year, or in the last 5 years, or in the last 15 years or even going back to as early as the Hunt Commission in 1972, the taxpayer is being told and presented with a bill to in effect through Government to come in and help make up for the deficiency in the savings and loan insurance fund.

So the citizen is sort of looking at all of this and if they were listening to this conversation would say, you know, if this thing has been in the making for 17 years in effect, as we have just been tracing the history and it really was gathering momentum in the late 1970's and crossing over into the next decade and then picked up steam through the 1980's, and then all of the creative and phony accounting getting layered in on top of it, the other things we've just talked about, I think a citizen trying to kind of just get to the bottom line of all of this would sort of say well, how could it be that there could be in a sense one assumes a kind of general consensus that that was the way to do it at the time?

In other words, you have an awful lot of parties at interest when you think about it. You've got regulators, you've got Congress, you've got the industry, you've got the private accounting profession, you've got any number of people, the legal profession, all of whom are sort of parties at interest in this whole area as you're coming down through this period of something close to two decades, but even if you just take the last decade as the time when things really continued to mushroom in size, and I think the citizen is likely to say how could it be that, you know, with so many parties at interest and all pretty savvy players in all of this thing, that it could not be seen that we were on a track that was going to lead to a very sad end?

What would be your response to that? I mean how could that be?

Chairman BREEDEN. Well, I think there were several factors. One certainly was very significant. I don't want to overstate it, but I think its importance has probably not been understood nearly as much as it should be. That is the impact that these accounting rules have. It's fair to say that there are a great many people whose interests are affected, and certainly the taxpayers who stand behind the insurance fund should be first on that list, and certainly other regulatory institutions, the Congress and other groups have interests that are affected. But you have to remember that there are thousands of institutions that are putting forward a financial statement, a balance sheet and income statement that shows that they are in the pink of health—there is the capital, it's at this level, it's rolling in every year.

The CHAIRMAN. And the numbers all add up.

Chairman BREEDEN. And I don't think that you can expect those of us who are not trained accountants and are not typically in the habit of going back, particularly where financial statements of that kind have been overseen by a primary regulator whose job it is to make sure that those accounts are accurate, to question the fact that the accounting statements show a $32 billion positive figure, when in economic fact there is $120 billion to the negative. The importance is the decision to allow the accounting rules to be used to cover over and obscure from public oversight the size of the problem. In this case the Bank Board had a fair ability on its own to make those decisions.

One of the things that I'll mention later and is described at length in this testimony—and I know this committee is familiar with the long-standing view of the Securities and Exchange Commission, endorsed, I might add, by all the Federal financial regulators and in 1985 recommended by the Bush Task Group—is that the accounting statements and disclosures that are made by institutions that are selling stock to the public should be overseen in all cases by the SEC and not by the specific regulator of that firm.

Now, the SEC has jurisdiction when every type of public company goes to market in the United States, about 11,000 public companies. We review the prospectus for every one, except banks and thrift institutions that aren't part of holding companies. In that case it's the specific regulator, the FDIC, the OTS and the others that look at those prospectuses.

So, during this period of time not only were these accounting principles and statements being reported to the regulator, but they were also being used for the basis of hundreds of public offerings of securities, and those offerings were being overseen not by the SEC, but by the Federal Home Loan Bank Board.

The CHAIRMAN. Unless a thrift or a bank is part of a holding company.

Chairman BREEDEN. Holding companies are very common in the banking industry. In fact, we oversee the offerings of virtually all the large institutions by virtue of that, but holding companies were relatively uncommon in the S&L industry. Because of their powers to have service corporation subsidiaries, and because their asset powers in the S&L or in an S&L subsidiary were much greater, they really didn't need to have holding companies.

So, in the S&L industry most of the offerings were in fact occurring under the Bank Board rather than under the SEC, and that reinforced this problem. Had those filings occurred over at the SEC, at least there would have been a chance that another point of view would have been brought to bear, that someone else would have had an opportunity to second-guess those decisions.

I know Senator Wirth has a bill that has been introduced to accomplish this purpose, and that's legislation that we would still strongly urge that the committee take up. It would be a great improvement in the existing system.

So one reason, to go back to your question, is simply that the rules obscured this.

The CHAIRMAN. Let me just say before you go any further that your points are exactly right, although some of the most celebrated notorious cases we know about in the thrift industry in fact were

looked at by the SEC and under the control of the SEC with respect to their clearance processes.

Chairman BREEDEN. That is true, and I'm not going to sit here and say that——

The CHAIRMAN. No, no, and I'm not asking you to because you weren't there at the time in any case. I'm simply making the point that even with those instances where the SEC did have an oversight responsibility, it looks to me as if the SEC itself was misled by some of the accounting standards or some of the representations made.

Chairman BREEDEN. Well, if I might correct your view on that just a little bit. We took some positions—and when I say we, I mean the agency at that time—we took some positions that were different than the Bank Board's. For example, the Bank Board was permitting up to 40-year amortization of goodwill on acquisitions. The SEC simply flatly refused to allow 40-year amortization and advised all thrift holding companies that 20 to 25 years was the maximum that they could use period, full stop. That simply was the decision of the agency, and it refused to allow what it regarded to be unjustifiably long amortization periods.

We also took action in the Financial Corporation of America case where the institution, then by far the largest thrift institution in the country, was engaging in very speculative transactions—what they called dollar rolls—which were essentially forward commitments to buy securities, and had booked $155 million worth of income on these transactions.

That was inappropriate under GAAP in the judgment of the Commission, and it was the SEC that forced FCA to go in and restate its financials and take out the phony income. That in fact triggered a run or a liquidity problem for FCA and ultimately the institution was closed and had to be recapitalized. But it was the Commission that took action in that case.

We have brought cases against Continental Illinois, First Chicago, Southwest Bank Shares, and a very large number of financial institutions that did report to us. I might add that in some of the matters that occurred over the last few years, we are still actively investigating, and there will be some other cases that will be filed in some of these instances to which you refer. So, I think we are dedicated to a good, sound and tough set of accounting principles applied nationwide.

The CHAIRMAN. As an advocate of yours in terms of your confirmation before this committee, I'm convinced of that, and you've shown that leadership since being at the SEC and before.

But with respect to other things that the SEC does, and you've given us some cases that go back into the early 1980's and some things that were done, and I don't know how many there would have been sort of in the later 1980's, but I am right in understanding, am I not, that the SEC would also have to clear any bond sales by S&L's that were part of holding companies, would they not?

Chairman BREEDEN. Well, clear in the sense that if it's not an exempt transaction, if it's a public offering, then the prospectus for that offering would be filed with the SEC in the same way——

The CHAIRMAN. Yes, the 11,000 you talk about or what-have-you that you would have to do.

Chairman BREEDEN. That's correct.

The CHAIRMAN. But even there the SEC presumably, I mean you're not going to do a perfect job, you try to do a perfect job, but again doesn't the SEC have to rely on the accounting that is offered with respect to what you're given, or do you do an independent accounting assessment of the documents you're given that fall into that category?

Chairman BREEDEN. Well, we don't review exhaustively every filing with us, but we do selectively review documents. And in fact we review all initial public offerings, for example. Repeat offerings we sample periodically, but we look both at the text of the disclosure and do an accounting review, and there are many occasions in which we will not permit accounting that we believe is not sufficient with respect to our accounting rules and GAPP accounting. We can prevent the institution from going to market.

In the case of depository institutions, the typical kinds of problems that often arise may relate, for example, to the size of loan loss reserves. That's a particularly frequent one, and there you have a situation in which we have to understand that these institutions do have a primary supervisor and that it's their job and not ours to decide what percent of a given loan portfolio needs to be reserved against and needs to be written down.

So, I think there is somewhat of a tension, if you will, in that we would not want to second-guess in an inappropriate way the decisions of the primary examining agencies as to the level of loan loss reserves, which has a huge impact on net worth and earnings.

The CHAIRMAN. Are there any examples where the SEC gave an approval, for example, to the sale of bonds for banks or thrifts where in fact we later learned that the numbers were phony and the people lost their money? I assume there have to be some cases like that.

Chairman BREEDEN. Well, there are certainly a number of cases in which subsequently the companies encountered problems, and I would not want to suggest they are limited to the banking and thrift industries.

Let me just make one small caveat so that people do appreciate the system that exists under the securities law, which is that offerings are made by the issuers. We do review them, and if we note a problem on the face of the filing, we can take action to restrain it. But under the law the institution is free to go to market unless we can prove in court that the offering is being made on the basis of false or misleading information.

So, we have an ability to comment and we have an ability to delay, and of course institutions sometimes do not wish to provoke us into bringing actions against them and highlighting their problems. They usually prefer to correct the filings. We don't approve each issuance of securities before it's——

The CHAIRMAN. No, but you go over every single prospectus. That's what I heard you say before.

Chairman BREEDEN. No, we don't even review every prospectus. We do selective reviews. In certain types of transactions like initial public offerings we review every one of them.

The CHAIRMAN. I see.

Chairman BREEDEN. In other things like bond offerings, they are filed with us, but if it's the 10th offering of securities in an 18-month period, we don't always review fully every filing that is made with us.

The CHAIRMAN. If it's the first one do you do the review?

Chairman BREEDEN. Well, usually in transactions that are the first of a type. We have some targeting methods that we use to try and focus our review on the offerings that are most significant.

The CHAIRMAN. What I'm getting to though, and I think you've just said it, and if I don't have this right, correct me, and that is that when you go through the review in a situation where review is warranted, and you have a very substantial review capacity, I mean that's a very important part of what the SEC does, you still for the most part are relying on accounting information that is given to you, and I assume that, you know, I mean you can't in each and every case go out and employ a separate accounting operation to go out and check and see if what is being certified by a certified accountant firm is or is not accurate. I mean there has to be some basis upon—I mean what sets off the red lights, and what sets off the alarm if you see something that doesn't look right.

If an analyst is going through a filing and sort of reads it carefully and so forth, presumably they are putting some very considerable reliance on the numbers that are presented; isn't that correct? I mean what sets off the alarm bells?

Chairman BREEDEN. Well, I can first agree with you in the general proposition that, yes, we do rely very heavily on the fact that issuers have independent accounting firms. In fact firms that are issuing securities are not required to have an underwriter, and they are not required to have outside counsel, but the one party that is required to be a part of any offering of securities is an independent outside accounting firm. So we do rely on the fact that there are audited financials.

In the case of a bank or a thrift, or in the case of a filing by a holding company where the principle assets, the principle earning stream, is coming out of a regulated bank or thrift, in addition to relying on the fact they have outside accountants, the fact that the financial statements of the bank or the thrift have been presumably carefully examined by the OCC, the FDIC and the Fed, whichever agency has responsibility, is also a factor that is very important. That is not to say that we don't reserve the right to disagree, if we find a problem or if we disagree with the treatment that is involved, as we did in FCA where the Bank Board tolerated the dollar rolls and where the SEC said we're sorry, we can't live with that treatment and we believe a restatement of results is required. But there is, in the general course of things, a great deal of reliance that we place on both the underlying regulator and the accounting firms in looking at the financials.

The CHAIRMAN. Well, I take the time to do that because it's very importantly illustrates what you're here to talk about today, and that is that if the accounting treatment in and accounting information, and I'm not talking about just deliberately doctored information, but if the underlying makeup of the information is unreliable or unsound, I mean the system can't work that way.

In other words, it seems to me if we don't find a way to address that and get to real accounting and to real market values and have an iron discipline in that area, you know, we're going to have any number of accidents waiting to happen, whether they are deliberate or not deliberate. The fact is that a system that is built on those kinds of practices just can't work right.

Chairman BREEDEN. I do have some comments later on the general subject of mark-to-market accounting, but I think that, particularly in financial institutions, whose portfolios consist of financial instruments that have, in many cases, a readily ascertainable value, certainly in the securities portfolios, it would be regrettable if we continued to have accounting statements that essentially needed to have at the top of the balance sheet the phrase "once upon a time."

The CHAIRMAN. That's right.

Chairman BREEDEN. And maybe "in the galaxy far, far away." I mean, we know that what's important is the economic worth of this institution and not what it once looked like whenever it made investment decisions for its portfolio—perhaps many, many years ago. That really, other than to historians, is of relatively little importance. Certainly it's not of importance to investors or to the FDIC. The insurance fund will incur losses based on market value and not on cost, the carrying cost, or the original historic cost of assets.

But I would also agree that we are affected very much by accounting policies and accounting decisions that are made, and interpretations of those policies by the specific regulators in the bank and thrift area, not only when we're reviewing a prospectus, but also when we are considering enforcement action. If we intend to bring an action against someone for violating good accounting principles and they are able to present a defense that says well, our primary regulator reviewed these financials and said they are fine, it obviously makes it a somewhat more difficult case.

Now I'm not saying that is often the case, but on some of these things where the agency, as a policy matter, adopted a specific accounting principle that was designed, that was calculated to overstate, if you will, true economic net worth, it becomes increasingly difficult for others to attack that once that position is taken.

The CHAIRMAN. Why shouldn't the SEC set the accounting rules? What is the rationale for allowing the Financial Accounting Standards Board to do that in effect for you?

Chairman BREEDEN. Well, we have ultimate authority over the accounting principles that are promulgated. The Commission historically has chosen to defer the establishment of standards to the professional accounting bodies rather than trying to do it within the agency, and I think that was a sound decision.

I think we also have to realize, though, that we have a responsibility, that we cannot necessarily just stand back and say that we will wait until the principles are presented to us. There are areas, such as the issue of whether we should be moving toward market value accounting at a more brisk pace than has occurred in recent years, where I think the Commission needs to consider appropriate policies and at least make sure that those issues are being fully considered by the professional accounting bodies.

I think it's a great strength of the accounting rules that we do have not just the decisions of an agency, as occurred in the setting of the thrift accounting principles, but principles that are defined through a very careful and extensive process of consideration within the accounting profession and all the affected private concerns and that is overseen by the SEC. I think that's generally a good process and perhaps has more resilience and strength than if any single agency, our's or some other one, were simply declaring accounting rules by fiat. I think that would probably be a weaker system.

I won't belabor the remainder of some of these differences, but just to touch briefly on some of the other items, I had mentioned, Mr. Chairman, some of the RAP policies that were completely at variance with GAAP. There were other areas in which the interpretation of GAAP varied from the interpretation that was utilized in other industries.

For example: the question of what period could be utilized for amortizing goodwill; and questions of matching the amortization of purchase discounts--in the income statement with the amortization of goodwill on the expense side of the ledger. Some timing differences that were allowed—again through interpretations of GAAP rather than a specific standard itself; and techniques of purchase accounting that were utilized in the thrift industry were, in fact, extremely significant.

In 1982 alone there was $15 billion in goodwill booked as assets by thrifts as a result of mergers, in many cases involving what were called Phoenix transactions with three or four unsolvent institutions merging, and accounting utilized to write up the difference between their book value and their real value and create that as an asset on the books as goodwill. So, we had in effect the creation out of thin air of $15 billion in that year of value called goodwill.

Now that grew ultimately by the time FIRREA was enacted to more than $20 billion in goodwill that was being carried as part of the net worth and in the capital computations of the thrifts. That level of goodwill is enough at the then current level of capital requirements to support over $600 billion of loans for as long as 30 or 40 years.

The CHAIRMAN. Some estimates of the total losses are in that range. I mean not that one directly connects to the other, but one might argue that that item alone was sufficient to lever up something close to the total amount of losses that we're going to see in the system.

Chairman BREEDEN. Well, it was enormously significant. In fact, one of the charts we have demonstrates that in 1982 goodwill as a percentage of GAAP capital for FSLIC insured institutions went from 6.48 percent in 1981 to 81.8 in 1982. It got as high as 88 percent in 1983 and 1984. So that an industry was growing at an enormously rapid rate based purely on——

The CHAIRMAN. Well, it was growing out of its problems. Wasn't that theory?

Chairman BREEDEN. That was the theory—what I have sometimes referred to as the dare-to-be-great school of banking. If you have a small insolvent institution, why not double or triple its size

and hope that when you're through it will be in better shape than it was when it started. I think the results are clear, and they proved disastrous. Frankly, I think if an institution's private creditors wanted to forbear—as happens every day as part of the chapter 11 process or even before a bankruptcy filing——

Creditors may make a decision to under certain conditions——

The CHAIRMAN. That's what they're doing with Donald Trump. The banks are doing it to Donald Trump right now.

Chairman BREEDEN. It happens every day, and if you're forbearing with your own money, that's one thing. But to say that we're going to ask the American public to be on the hook for a game of double or nothing is, I think, a very different matter. These accounting rules were at the heart of how this was able to occur within the nominal appearance of solvency of the system and how the ultimate resolution of the problem was able to be postponed so long.

I do think, and I hope this doesn't sound unduly self-serving, it's to the great credit of the President of the United States, President Bush, who within 17 days of taking office had the courage to finally stand up and say that this is a cancer that has been growing in the financial system for decades and we're going to put an end to it, and came to the Congress with a plan to do that.

And I think it's to the very great credit of this committee and to your chairmanship that the committee responded to that, and that we didn't have a situation, as occurred in early periods, where some of the fixes took years to work through the legislative process. We did develop tangible capital requirements and tough accounting rules, and the very item you were discussing this morning with the bank regulators—a requirement that the thrift capital rules in perpetuity be raised to the level of bank rules, that they could never be reduced from that, and a requirement that the accounting principles used in the thrift industry match those used in the banking industry.

All those things that were accomplished as a part of FIRREA were the right thing to do, and they have been very important in reducing the chances of a further repetition of this. Sadly, they happened in some cases many years too late, but I think they represented very important steps, given what I think the origins of this problem were.

The CHAIRMAN. Well, you know, you've said something, and I appreciate your kind personal reference there a moment ago, but you've said something that I think is very important today in the midst of all of this that helps make this something that can be understood, and that is that with this long history of this build-up and overlaying of problems without going back and enumerating all of the different items, but coming off this big interest rate jump and deregulation and interest rates and so forth, you're phrase a moment ago that it was sort of a double or nothing strategy, and as we were as a nation coming down through the 1980's and as this problem was more and more apparent, it seems to me that all of these different techniques that were added on the margin, the accounting techniques and the net worth certificates and allowing good will to count as capital and all these different stretches and techniques were designed to in effect work the problem out.

I mean the theory was here are these big losses that are embedded in there and maybe there is a way in effect to have the future success cover the past losses, and it was in effect a double or nothing bet or a triple or nothing bet, whatever, but it didn't work.

You know, I don't know that anybody even wants to spend the time right now to think about that fact, but I think in a sense in terms of the anatomy of this, almost a 20-year odyssey or at least a 15-year odyssey, that's what happened, and we may be in the process of doing something like that right now in the banking system. I don't say on any one-for-one comparison basis, because the situations are quite different, but let's hope we're not. But we certainly have an example of where I think there was a consensus to go the double or nothing route and, unfortunately, instead of getting nothing we got double.

Chairman BREEDEN. Well, Mr. Chairman, I think as you point out, the situation in the banking industry is very different. The banking regulators have always required positive levels of capital, and the divergences between RAP and GAAP in the banking industry have generally been to tighten GAAP rather than to weaken it. So I think there are some very important differences that I think should not be overlooked.

The CHAIRMAN. Absolutely. That's exactly right.

Chairman BREEDEN. And I think it's to the great credit of the banking agencies that they have been willing to force very substantial increases in capital where that was required by the operating circumstances of the banks, and they are continuing to keep on that pressure. The history there is very, very different.

I would say it is a legitimate question of not only economic policy, but political philosophy as to who should be the party to make a decision to forbear, to enter into a workout rather than cutting your losses and putting an end to further operation of an insured institution. There is a temptation sometimes on the part of those who are closest to a situation to seek to continue to work on that situation, or perhaps to engage in a rescue that is broader than needs to occur.

I know this committee has spent a great deal of time looking at the way in which some of the failures of very large institutions have been handled in the banking industry, and there is a great deal of debate within the industry over the so-called too-big-to-fail doctrine. Recently, we have seen some cases that are inexplicable under that doctrine, given the size of the institution, where creditors who were not within the scope of deposit insurance were in fact nonetheless made whole. I think it is a fair question to ask, what the standards should be for those types of forbearance decisions where the credit of the public ultimately is at stake. I think the agencies need guidance in that area so that we have an understanding of the degree to which chances of further losses should be run versus recognizing that a given problem is insoluble.

I know the agencies do the very best job that they can in making those judgments. They do need to have case-by-case flexibility because the judgments that they have to face are not cut and dried. But it's difficult to define what the parameters ought to be for how long a given situation will be allowed to continue, and, if it is going to be brought to an end, then what creditors are going to be paid.

We have nominal decisions in the insurance program as to who is entitled to be paid, but sometimes people who are not legally entitled to be paid also are made whole because of the way the transaction is covered. I think, there again, that is something that the insurance study being done now will undoubtedly look at, the scope of that protection.

The CHAIRMAN. Let me ask you now, and we've engaged in sort of a running colloquy here, and that's a privilege that we seldom have, but because of the fact that we don't have other members here presently, we've been able to conduct something of a dialog.

I want to make a point related to this, but I'm very mindful of how much longer you will need with respect to the statement, the summary statement that you're delivering, and I want to hear it all. So can you give me a sense as to how long that takes?

Chairman BREEDEN. Oh, I could blaze through it here in about three or four more minutes.

The CHAIRMAN. All right. Our colloquy has covered a lot of the spots that we will——

We've covered a lot of these things, but I want to put one other thing in here, both for your mind and also for the record because as we have gone back to do all the detective work to reconstruct this history, and you have added very importantly to it today, and I think you have been able to shine some light on aspects of this problem more clearly and meaningfully than we have had before, and I thank you very much for that.

One of the things that has been very striking to me that relates to this as we have looked at this pattern of sort of trying to leverage our way out of the problem over a long stretch of years and sort of doubling the bets and hoping that it would work and finding sadly at the end that it didn't is as we now are looking at the sort of harvest of RTC assets coming into repossession and the failures and losses across the country, we have found that there was one more stretch that was sort of put on the end along with the various accounting treatments and other things that you've mentioned, and that was this use of State powers under this dual banking system that we have where States were allowed to take and very broadly expand the operating charters to find ways to use that money off this high leverage system that you described earlier, and we have found that in the last now 3 years, roughly 3½ years that 67 percent of the losses in the entire savings and loan system have occurred in State chartered institutions in just two States, Texas and California, and that about, and I'm doing this from memory, about 65 or so percent of the total assets in possession of the RTC now, and they are in every manner and shape in terms of the type of asset, but about 65 percent of the total assets are found just within the boundary lines of the State of Texas.

Now some are other places, but you see this remarkable concentration of loss at the end, and as you start going back through you can start from today and work back through the problem over 10, 15 or 20 years, you can start in the early 1970's and work up, and you get the same story either way. But in terms of the thing that finally blew a gaping hole in the side of the ship on top of the phony accounting and a lot of other things I think was this exten-

sion of Federal deposit insurance to State powers which went way out of bounds and we have stopped that as well in the FIRREA bill.

But I don't think again in that area there was ever a recognition of the scale of the multiplication of risk that was being set in motion partly because we've got this dual system in our society, and it's just interesting to see how powerful the summary data looks when you look at it because it so atypical that it tells a story of its own.

Chairman BREEDEN. I think that's a very important question, Mr. Chairman. Of course, in those States the percentage of aggregate assets was also very, very high. I'm just recalling from memory that 31 percent of all the assets in the United States of America held by the thrift industry were in State chartered California thrifts. So it stands to reason that they had an awful lot of the losses because they had an awful lot of the assets.

The CHAIRMAN. But they did because they had a particular kind of charter. If they had had a charter like existed in most of the other States in the country, that money wouldn't have been there.

Chairman BREEDEN. Well, there was unquestionably, I think, competition among the chartering entities to offer a less restrictive environment in some areas, and up to a point that is very healthy. When the New England States developed the NOW account——

The CHAIRMAN. Well, would you say that this aggregate data suggests that maybe we went past that point?

Chairman BREEDEN. Well, I think that is a fair inference from that data.

The CHAIRMAN. I mean when you get t· ɔ-thirds of the losses in two States in just State chartered institutions in those States, and you get—my number was low—it's 69 percent of the total value of the assets in the RTC as of June 12 of this year, 69 percent were in the State of Texas. Within one State. Forget the other 49 States.

Chairman BREEDEN. I am not going to sit here and justify that in any way, shape or form, because I think you and I share a revulsion for some of the practices that occurred in this industry. I am not going to say that the absolute unlimited pouring of funds that some States permitted into wind farms and every esoteric investment that people would think up, including investments that were utilized by the thrift officers personally, should have been allowed. The freedom under State chartering statutes that Texas and California, Florida and a few other States gave was an element of this picture. But I cannot excuse the Federal Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board, who shouldn't have given those thrifts the money in the first place, because you can't do any damage with asset powers if there is no cash in the till. And it was the Bank Board and the FSLIC that had the power, like the FDIC had it.

We have State chartering statutes in banking, and States can authorize broader authorities, but the FDIC doesn't feel that it is required to bankroll all of those activities by institutions that don't have capital. So, my personal view is that those authorities in some cases led to certain abuses, but those abuses wouldn't have happened had we not had this saga of ignoring capital requirements and allowing unbridled growth and giving them the money. The Federal Government, the Federal insurance regulators, could have

prevented that and I think were found wanting in doing that and didn't do the job.

So it is kind of a chicken or the egg problem as to which came first here, but I focus on the fact that we allowed institutions that were already insolvent to essentially go out and borrow $650 billion from the public and play double or nothing. That was a decision that otherwise should not have happened. The American public would not have given $600 billion to the savings and loans of America except for one thing, Federal deposit insurance.

The CHAIRMAN. Yes.

Chairman BREEDEN. So I believe that the root of this problem was a combination of these accounting principles and the insurance device which produced the cash. Without the cash, the losses couldn't have occurred.

If its all right with you, I'll just finish off this statement here.

The CHAIRMAN. Please.

Chairman BREEDEN. We have touched on it already, but I would like to particularly address the question of market based accounting and mark-to-market accounting.

The CHAIRMAN. It's key. I mean this is I think some of the most important testimony you've given us in your prepared statement, and I really want to hear that.

Chairman BREEDEN. Under current practice, GAAP generally accepted accounting principles for banks and thrifts are based principally on the historic cost framework. These institutions are permitted to carry assets on their books at their amortized cost, even in those instances where the current value of the assets has eroded substantially and where a market based standard would provide a far more accurate measure of the institution's financial health.

As we enter the decade of the 1990's, we should consider a fundamental shift in the goal we set for accounting standards for financial institutions. Financial institutions are in the business of buying and selling financial instruments, all of which have a specific value measured in terms of current market conditions. Determining the value of an institution's assets and not recording their original cost should increasingly be the goal toward which we should work.

The Nation's experience with the crisis in the savings and loan industry, as well as with many of the largest bank failures demonstrates the inherent and very substantial dangers of a reporting system for financial institutions that is premised on historical cost accounting principles. Market based information can permit regulators and investors alike to make a much more meaningful assessment of the real economic value and risk exposures of a financial institution. Knowing current market value also allows regulators to take appropriate actions before a situation deteriorates irretrievably.

When a financial institution becomes insolvent the loss to the insurance fund and ultimately to the taxpayers is measured based solely on the market values of its assets and liabilities—historical costs are irrelevant in that process. Therefore, the risk exposure to the insurance system should be calculated on the same basis that its ultimate obligation will be calculated. Although in some cases market values cannot be precisely measured where you have some

illiquid instruments such as longer term commercial notes, for example.

It has been appropriately noted that the best possible estimate of a relevant concept is better than a precise measure of an irrelevant one. And there are certainly, if we put our minds to it, ways in which we could develop techniques for valuing even illiquid assets for which there is no readily quoted market value available. One possibility would be, perhaps, to develop haircuts on the value of such assets based on their age. That would in turn create an incentive for the creation of secondary trading markets for some of these instruments that would make institutions' portfolios more liquid.

While some have argued that mark-to-market accounting would produce unacceptable volatility in operating results, market-based accounting has long been required of broker dealers and investment companies. Thus, firms such as Salomon Bros., Merrill Lynch and others with tens of billions of dollars in securities positions routinely use daily mark-to-market accounting without such problems. So, too, mutual funds with hundreds of billions of dollars in securities positions utilize daily mark-to-market accounting. It is therefore questionable whether this method of reporting by banks and thrifts would produce significant problems, especially as to their holdings of marketable securities, irrespective of whether they have a trading or investment intent, which, of course as you know, is the standard utilized under current practice. If the securities are held with an investment intent, then GAAP permits them to be recorded at cost even if their current value has shrunk dramatically. If they are held for trading purposes, then they must be valued at market.

My own personal belief is that our accounting system should seek to reflect economic value and not psychology, and I think the time and effort that is spent on determining whether an institution had the intent of trading instruments or of holding them to maturity is a very slippery standard to try and apply. It's very costly and is susceptible to a considerable amount of manipulation by institutions in various forms, and I think that we have to give very careful attention to whether that distinction has any remaining validity.

We recognize that the transition to full value market accounting is a complex undertaking. Studies are currently underway concerning these issues at the Treasury Department in the accounting profession. However, the Commission believes that the objective of these efforts should be to achieve financial reporting that uses appropriate mark-to-market based measures of valuation at the earliest possible date.

The Commission also recognizes that the move to a full-scale application of market based accounting requires careful and deliberate planning. In particular, we do not underestimate the significance or importance of problems of cost, problems of subjectivity of estimates and other specific issues that have been raised with respect to market based accounting. However, we do believe that resolution of these problems should be aggressively pursued.

The thrift crisis confirms that effective regulation of financial institutions requires adherence to sound accounting principles. It is essential, for the purpose of both financial reporting and regula-

tory reporting, that financial institutions adhere to accounting standards that result in an accurate portrayal of an institution's financial position and results of operation.

I would hope we would learn from the disastrous experience of the thrift crisis as we move forward in developing both accounting and disclosure standards. Although accounting techniques were used to enhance the perception that thrifts were operating on a safe and sound basis, we know sadly from experience in many cases they were not. In the future I believe that we must seek to become aware of insolvency or financial crisis at the earliest possible time and not when it's already too late.

[The complete prepared statement of Richard Breeden follows:]

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING ISSUES INVOLVING FINANCIAL INSTITUTIONS
AND ACCOUNTING PRINCIPLES

BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

SEPTEMBER 10, 1990

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

STATEMENT OF RICHARD C. BREEDEN
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING ISSUES INVOLVING FINANCIAL INSTITUTIONS
AND ACCOUNTING PRINCIPLES

September 10, 1990

Good morning Chairman Riegle and Members of the Committee.

I am pleased to be with you again this morning to discuss the accounting principles utilized by financial institutions. As recent history should vividly demonstrate, the accounting principles that federal regulators promulgate or permit financial institutions to utilize can have an enormous impact on the appearance of solvency of firms, as well as on the rate of their growth and the pattern of their risk-taking. If misused, accounting principles can conceal insolvency from creditors, investors and regulators. In some cases, as with the thrift regulators' dilution of accounting standards, discussed below, the accounting rules may facilitate fraud on investors. In other cases, accounting principles may be used to justify postponing treatment or resolution of even fatal problems in particular firms at the very time they may be expanding through the use of publicly-guaranteed funds.

Misuse of accounting standards played an extremely large, and in some ways pivotal, role in allowing the rapid and reckless growth of the thrift industry, as well as in concealing the depth of its problems. In response to the Committee's

inquiry, this testimony will seek to trace the role that misuse of accounting principles played in the collapse of the thrift industry. At the outset it should be noted, however, that many other factors were involved in the creation of this problem over a period of decades. The availability of federal deposit insurance was obviously a prerequisite to the willingness of the public to add more than one-half trillion dollars in deposits with thrift institutions in less than a decade. Other factors included chronic underfunding of the Federal Savings and Loan Insurance Corporation ("FSLIC") through inadequate premium levels; fundamental conflicts of interest in the structure of the regulatory system; excessive influence by the regulated firms and their trade association over the Federal Home Loan Bank Board ("FHLBB"); statutory forbearance requirements and other causes. Since these issues are beyond the scope of the Committee's inquiry, they are not addressed by this testimony.

In the following testimony, I hope to answer the specific questions posed by the Committee and to address three broader themes. First, I would like to describe the role played by specific regulatory accounting principles ("RAP") and inappropriate or unique interpretations of generally accepted accounting principles ("GAAP") in the growth, and ultimate collapse, of the thrift industry overall. Second, I would like to review how the operation and impact of specific accounting standards and regulatory interpretations adopted by thrift regulators facilitated the distortion of capital levels and the dramatic expansion of loan and investment activities by thrifts. Finally, in discussing the issue of the "trading" portfolio versus the "investment" portfolio, I would like to review the broader issue of

market-based accounting and its bearing on the proper role of financial accounting for financial institutions.

I. THE ROLE OF CAPITAL REQUIREMENTS AND BUSINESS EXPANSION IN THE THRIFT CRISIS: ACCOUNTING FACTORS

A. The Systemic Industry Problems

As the Committee appreciates, the assets of savings and loan institutions traditionally were concentrated in long-term, residential mortgage loans, typically at fixed rates of interest. These mortgage loans were largely funded by very short-term deposits. This fundamental maturity imbalance between long-term assets and short-term liabilities meant that the net worth and earnings of thrift institutions were inherently vulnerable to interest rate fluctuations.

At the same time, federal law capped the rate of interest that could be paid on bank and thrift deposits. This made thrifts vulnerable to periodic bouts of disintermediation when market rates exceeded permissible interest payment ceilings. While the rate ceilings created periodic problems in funding new mortgage originations, they also acted like a governor on an engine to prevent it from running too fast and overheating. Because rates were limited, it was very difficult for institutions to grow rapidly in size. Small problems, therefore, tended to remain small for extended periods of time. This gave even a slow regulatory system the time to discover and to correct problem situations.

In the 1970s, the nation experienced extended periods of inflation and interest rate volatility, and new consumer-oriented financial products, such as money market mutual funds, were developed that paid market rates of interest.

Depository institutions lost large volumes of their controlled-rate federally insured deposits, and they did not have the authority to offer comparable uninsured ... products. In response to these developments, regulators authorized thrift institutions in May, 1978 to offer six-month money market certificates in $100,000 denominations priced slightly above U.S. Treasury bills of the same duration. 1/ Then, in 1980, Congress enacted legislation that, among other things, created interest-bearing checking accounts for individuals and established a schedule for the deregulation of interest rates paid to depositors. 2/ The 1980 legislation also vastly expanded the scope of federal deposit insurance by increasing the amount of insurance per account from $40,000 to $100,000.

Following the expansion of the deposit insurance coverage and the removal of all rate limitations, depository institutions were suddenly able to raise virtually unlimited volumes of deposits. Depositors were largely indifferent to the financial health of the institutions to which they lent money because they were shielded by federal insurance. A brokered deposit business emerged to direct deposit money toward institutions paying the highest rates of interest, which were generally the institutions representing the greatest risk. Thus, a system of slow growth due to

---

1/ See FHLBB, "New Certificate Accounts," 47 Fed. Reg. 21,438 (1978).

2/ Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.).

limited funds availability was replaced in a very brief time with one in which institutions could raise and lend out vast sums in a very brief period.

Few, if any, market restraints existed due to the presence of government deposit insurance. This left a regulatory system, designed in many respects for a system of small, mutual institutions incapable of rapid growth, as the sole discipline for a vastly expanded industry now equipped with the funding equivalent of jet engine afterburners capable of sudden and dramatic acceleration of growth.

Throughout the 1970s and 1980s, thrifts also experienced increased competition and lower spreads from their portfolio mortgage lending due to the growth of increasingly efficient secondary markets for mortgage-backed securities. Thus, thrifts were no longer the dominant source of liquidity for mortgages, and the origination function often could be performed by mortgage bankers and others at much lower cost.

While the average cost of funds for thrift institutions rose from seven percent in 1978 to just over 11 percent in 1982, the preponderance of long-term, fixed-rate mortgages in thrift portfolios prevented a corresponding increase in revenues. In both 1981 and 1982, the average cost of funds actually exceeded the average return on mortgages. On a true market value basis, the thrift industry as

a whole was probably insolvent as early as the mid-1970s. Insolvencies became widespread during the period from 1978-1980. 3/

In 1982, Congress enacted legislation that accelerated the removal of interest rate controls by permitting new money market deposit instruments. This legislation also authorized federally-chartered thrifts to invest up to 40 percent of their assets in nonresidential real estate lending, and to invest as much as 30 percent of assets in consumer loans. 4/ These changes in federal law allowing greater diversification of portfolio assets by federally-chartered thrifts were modest compared to the actions of California, Texas and certain other states, which in the early 1980s essentially removed all portfolio or business activity limitations. 5/ Thus, statutory change at both the state and federal level altered the types of lending and the overall risk pattern of the thrift industry.

So long as it was done in a prudent manner, diversification of asset powers to allow thrifts to offer credit cards or to extend other types of non-mortgage loans was a means to reduce, rather than to increase, the risk structure of the thrifts.

3/ See E. Kane, The S&L Insurance Mess: How Did It Happen? 75 (1989). Kane estimates that in 1978, on a mark-to-market basis, the thrift industry had, in the aggregate, a negative net worth of between 6.87 percent ($35.1 billion) to 10.31 percent ($52.7 billion) of total industry assets. Kane also estimates that by 1980, the negative net worth had increased to between 12.78 percent ($78.6 billion) and 19.17 percent ($117.95 billion) of assets.

4/ Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.).

5/ See, e.g., Cal. Fin. Code Section 7250 (West 1989); Tex. Banking Code Ann. Section 852a (Vernon 1989).

Indeed, one reason for the problems of the thrifts was their dependence on only one basic product. Over time, other firms became more efficient in various aspects of mortgage financing, and it was difficult for most thrifts to diversify. In addition, thrifts had been restrained from reducing their interest-rate vulnerability due to fixed rate mortgages. Indeed, with strong Congressional support, the regulatory policies of the FHLBB during the late 1970s did not authorize federally-chartered thrifts to offer adjustable rate mortgages. These types of mortgages were not authorized for federal thrifts until June 1981. 6/

By the early 1980s, Congressional action to reduce the dependency of thrifts on fixed rate mortgage lending was long overdue. However, entering new lines of finance or other types of business, without experience or market share, often results in heavy start-up losses. By this time, most thrifts were already insolvent, though their financial statements did not have to portray this insolvency. As a result, many thrifts had to fund losses incurred in entering new lines of business with deposits, rather than absorbing such losses out of stockholders equity or earnings. Restricting new thrift lending powers to those institutions with high levels of tangible capital (or conducting such activities in separately capitalized holding company affiliates unable to draw on the capital or funding of the thrift itself) would have prevented sensible product diversification from having an adverse impact on the deposit insurance fund.

6/ See FHLBB, "Adjustable Mortgage Loan Instruments," 46 Fed. Reg. 24,148 (1981).

B. Thrift Capital Levels

One potential source of discipline, appropriate capital requirements, would have served both to assure that thrift owners risked some of their own money in the loans they made, and to provide a cushion against loss. More important, a meaningful capital standard would have served as a check against uncontrolled growth, since the permissible level of investment is directly tied to capital requirements.

The thrift industry was permitted to engage in unchecked expansion, however, because, starting in the 1970s and continuing into the mid-1980s, the thrift regulators consistently acted in a manner that eroded the discipline of a capital standard during the period when it was most necessary. In November 1980, the FHLBB lowered the minimum net worth and reserve requirements that thrift institutions were required to satisfy from five percent to four percent. It further reduced capital requirements to three percent in January 1982. Thus, just as thrifts obtained vast new abilities to raise deposits, the regulatory agency acted to increase industry leverage from 20:1 to over 33:1. See the attached Chart 1.

In practice, the discipline that might have been provided by capital requirements was significantly eroded by two other regulations of the FHLBB. These were known as the "five-year averaging" and "20-year phase-in" provisions. Whatever their original rationale, 7/ these provisions led to disastrous results

---

7/ Both provisions were designed, at least in part, to permit a gradual building of reserves and net worth by mutual institutions financing residential mortgages in local markets.

when used by institutions that could attract deposits on a nationwide basis and engage in commercial lending and direct investments.

The "five-year averaging" provision was adopted by the FHLBB in December, 1972. 8/ This regulation permitted thrifts to base the calculation of their minimum net worth and reserve requirements on average liabilities and deposits over the five year period comprising the year of the calculation and the preceding four years, rather than on current liabilities and deposits. 9/ This method of computation drastically lowered capital requirements for those thrifts that had expanded most aggressively.

For example, assuming a three percent capital requirement, if a thrift increased its deposits by 100 percent annually for five years, its capital requirement ultimately would be lowered by 61 percent. Stated differently, if a thrift accepted $100 million in new deposits it would require $1.16 million in additional capital, rather than the $3 million that would have been required without averaging (and the approximately $5 - 6 million that would have been required for a bank to accept the same $100 million in deposits at that time). To further illustrate the effects of five-year averaging, if a thrift with liabilities of $100 million experienced 1000 percent growth in one year (which was not

---

8/ 37 Fed. Reg. 26,579 (1972). The original provision called for three-year averaging. 36 Fed. Reg. 21,667 (1971).

9/ The minimum net worth requirement was computed as a percentage of total liabilities, and the minimum statutory reserve requirement was computed as a percentage of insured deposits.

unknown in the industry), its capital requirement for accepting and relending $1 billion in funds would be would only $9 million, compared with at least $50 - $60 million for a bank. The aggregate industry-wide reduction (or dilution) of the capital required to support the growth of thrifts due to five-year averaging was very significant. See Chart 2 for an illustration of the effect on capital requirements of five-year averaging in a hypothetical case.

The "20-year phase-in" provision lowered capital requirements for newly-chartered thrift institutions that had not reached their twentieth anniversary of deposit insurance. New thrifts using this provision determined their capital requirements by multiplying three percent of their liabilities by the fraction of twenty years that the thrift had been covered by deposit insurance. Thus, a newly insured thrift needed to have only one twentieth of the normally-required reserves and net worth (5 percent or 3 percent depending on the time period). By permitting a debt-to-equity ratio as high as 666 to one, this provision essentially eliminated any meaningful capital restrictions on growth for the newest and most inexperienced thrifts trying to break into a volatile and changing industry. 10/ The effects of 20-year phase-in on the leverage of a hypothetical thrift with capital of $1 million is depicted in Chart 3.

10/ Prior to November 1983, when the FHLBB eliminated the use of the 20 year phase-in provision by new applicants for insurance, a new institution could leverage $2 million in initial capital stock or pledged savings to support $1.3 billion in liabilities after the first year. See FHLBB, "Reserve Requirements and Policies Relating to Insurance of Accounts of de Novo Institutions," 48 Fed. Reg. 54,320, 54,324 (1983).

The reduction of capital requirements, when combined with the use of overly permissive accounting practices (discussed in Part II below), permitted thrifts that were teetering on a shrinking or nonexistent capital base to engage in high-velocity expansion. Indeed, from year-end 1980 to year-end 1985, aggregate thrift assets grew from $621 billion to $977.5 billion. During the same period, although RAP permitted capital to be shown as increasing, aggregate industry tangible capital fell from more than $32 billion to only $3.2 billion. See Chart 4.

Thus, in only five years, taxpayer risks grew by more than $400 billion, or more than 72 percent, while tangible capital levels were falling precipitously. With virtually no capital at risk, the operators of such thrifts had nothing to lose and everything to gain by adopting a strategy of rapid growth and enormous risk-taking. In fact, it was precisely those thrifts in the most precarious position that had the greatest incentive to engage in speculative business activities.

Whether financial regulators should have permitted the continued operation of troubled thrift institutions is a separate question from whether those regulators should have fostered accounting principles that had the effect of creating an <u>appearance</u> that those thrift institutions complied with capital requirements. If a decision was made to forbear closing institutions due to an expectation that a change in the economy or other factors would permit their recovery, that decision should at least have been made openly. Instead, accounting principles were modified in a way that allowed insolvent institutions to appear to have positive net worth, thereby creating, in effect, a "stealth" balance sheet. Through

accounting prestidigitation, net worth suddenly appeared out of a sea of insolvency.

In December, 1983, the Task Group on Regulation of Financial Services (Task Group), which was chaired by then-Vice President Bush and included the heads of all federal financial regulatory agencies, adopted and announced an initial recommendation that the FHLBB should be required to utilize the same capital standards as the Federal Deposit Corporation ("FDIC"), as well as the same accounting principles for determining such capital. Total thrift assets at the time of this recommendation were approximately $820 billion. These recommendations were included in the Task Group's final report, entitled Blueprint for Reform, which was issued in late 1984. 11/ Legislation to implement these recommendations was introduced in early 1987. Unfortunately, these recommendations were not enacted into law until the passage of FIRREA, signed into law on August 9, 1989. 12/ By the time this legislation was adopted, aggregate thrift assets were approximately $1.25 trillion, an increase of roughly $430 billion, or approximately 50 percent in the more than five years since the original recommendations of the Task Group to tighten thrift capital and accounting standards.

11/ See Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services 82 (1984).

12/ Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 and 15 U.S.C.).

II. HOW THE THRIFT ACCOUNTING TECHNIQUES FACILITATED EXPANSION WITHOUT REAL CAPITAL AND CONCEALED TRUE FINANCIAL CONDITION

A. RAP Techniques and GAAP Interpretations

The Committee's letter of request invites discussion of two separate issues: (1) the differences between GAAP and RAP, and (2) the extent to which problems associated with the thrift industry may have stemmed from a lack of adequate standards as opposed to a failure to enforce existing standards. These two issues are related aspects of the problems created by the use of accounting standards to create the appearance of solvency among thrift institutions that in economic fact were not solvent. 13/ Unlike the fabled "emperor's new clothes," however, the thrift accounting standards did conceal the underlying reality from most observers. Indeed, the appearance of earnings and solvency was used to justify not only expansion, but also dividends, enormous salaries, acquisitions, and many other expenditures that drained cash from failing firms.

"Regulatory accounting principles" are accounting standards established by regulatory agencies to monitor compliance with statutory and administrative requirements. In the case of federally insured depository institutions, RAP govern the financial reports that are submitted to the relevant federal oversight agency.

13/ While this testimony focuses on the impact of RAP accounting and the standards imposed by the regulators, it is also fair to ask whether these standards were appropriately applied by financial institutions and their outside auditors. As the numerous lawsuits against outside auditors suggest, there are substantial questions about whether auditors fulfilled their obligations.

The most legitimate justification for the use of RAP would be to require more conservative reporting of earnings or net worth by a regulated firm than GAAP might be interpreted to permit. However, the actions of the FHLBB relating to RAP over a significant period were designed to permit the firms overseen by the FHLBB to report an inflated net worth compared to that permitted by GAAP.

By contrast, generally accepted accounting principles are established by private sector standard setters such as the Financial Accounting Standards Board ("FASB") 14/ and the American Institute of Certified Public Accountants ("AICPA"). 15/ This development of standards by the professional accounting bodies takes place under oversight of the Commission. GAAP, including those principles that specifically address the financial services industries, provide the framework for the accounting measurements and disclosures that are required for the sale of securities and periodic financial reports by every type of public company.

Banks and thrifts that are not part of a holding company are the only firms exempted from the uniform application of the Securities Act of 1933 ("Securities

---

14/ The FASB issues guidance in the form of Statements of Financial Accounting Standards ("FASs"), Interpretations, Technical Bulletins, Statements of Financial Accounting Concepts and minutes of The Emerging Issues Task Force.

15/ The AICPA issues guidance in the form of Notices to Practitioners, Industry Audit and Accounting Guides, Statements of Position, Accounting Interpretations, Issue Papers and Accounting Standards Executive Committee ("AcSEC") Practice Bulletins.

Act") and the Securities Exchange Act of 1934 ("Exchange Act"). 16/ As a result of Exchange Act Section 12(i), four separate federal banking and thrift regulators -- not the Commission -- have the authority and responsibility to administer and to enforce the disclosure and reporting provisions of the Exchange Act with respect to publicly-held banks and thrifts. 17/ The anomalous result is that while 11,000 public companies, including 1,100 publicly-owned bank and thrift holding companies, are subject to Commission review, some 650 publicly-owned banks and thrifts that are not part of holding companies are exempted from Commission oversight.

One result of this splintered authority was that the FHLBB, not the SEC, presided over hundreds of initial public offerings of thrift common stock to the public during the years in which it was allowing the use of distorted financial statements for thrifts. Thus, the opportunity for another agency to require public disclosure of these thrifts' true financial condition was lost.

Having adopted standards which permitted net worth to be overstated, the FHLBB could not represent any meaningful independent protection for investors. Indeed, the FHLBB actually had an enormous conflict in overseeing the Securities Act. Every dollar of equity raised by thrifts from investors benefitted the FSLIC

16/ Securities Act Sections 3(a)(2), (5), 15 U.S.C. 77c(a)(2), (5); Exchange Act, Section 12(i), 15 U.S.C. 78l(i).

17/ These are Exchange Act Sections 12 and 13 (the continuous reporting provisions), Section 14 (the proxy provisions) and Section 16 (governing reporting of insider transactions and short-selling trading).

(part of the FHLBB). Thus, the agency with discretion over how much bad news investors should know about directly benefitted from every dollar that was invested. This same conflict exists today with the FDIC.

The Commission has long advocated repeal of Exchange Act Section 12(i) and modification of Sections 3(a)(2) and 3(a)(5) of the Securities Act, to remove these discrepancies. In 1984, all the federal financial regulatory agencies concurred with this recommendation of the Task Group on Regulation of Financial Services chaired by then-Vice President Bush, as a means of providing better and more consistent protection to investors at lower cost. These reasons have, if anything, become more compelling in the intervening time. As the following discussion will show, the fragmentation of reporting and accounting oversight also contributed to the thrift industry problems.

During the early 1980s, thrift RAP were significantly more liberal than GAAP. For example, thrift regulated entities were permitted by RAP to employ accounting techniques whereby:

- thrifts could increase capital by the amount that certain assets had appreciated above recorded depreciated cost, without recognizing the decrease in value of other assets;
- loan origination fees could be immediately recorded as income on a basis more liberal than GAAP would have permitted; and
- losses on assets sold could be amortized over the remaining contractual life of the asset.

Thrift regulators also tolerated flawed interpretations of GAAP that enabled the regulated entities to comply with the lowered capital requirements. As a result, regulated thrifts:

- amortized expenses of acquiring troubled thrifts over 40 years while booking income on the discounted market value of assets over 10 years;
- created intangible assets and income from assisted combinations of troubled thrifts;
- accelerated income on certain real estate investments; and
- capitalized losses on speculative forward commitments.

Thus, it was the interpretations of GAAP combined with RAP that masked the erosion of capital in the industry. 18/ Literally thousands of thrift institutions were not only permitted to continue operations, but even allowed to grow enormously in size, even though they were economically insolvent.

As Chart 5 shows, the application of GAAP would have resulted in a significantly larger number of thrifts being classified as "insolvent," in each of the years following 1982.

B. Use of RAP to Avoid Risking Capital

1. Appraised Equity Capital

Appraised equity capital, authorized by the FHLBB in late 1982, was a technique that allowed a thrift to increase capital by the amount that certain of its

---

18/ A more detailed discussion of the manner in which these techniques and interpretations were manipulated by the regulated entities to avoid real capital risk is set forth below.

capital assets (e.g., property and equipment) had appreciated above their recorded depreciated cost. 19/ The rule permitted thrift institutions to recognize appreciation in the value of buildings even where those assets had not been sold, with a corresponding increase in net worth for RAP purposes.

As discussed in the last section of this testimony, a market-value approach to accounting rather than historical cost should be utilized wherever possible to provide a more accurate picture of an entity's net worth. However, the thrifts were implementing this approach highly selectively. Indeed, only adjustments that increased the value of certain assets were made, and there was not any obligation to recognize the far greater decrease in value of other assets.

The appraised equity capital rule became ineffective as of December 31, 1986. 20/ During its life, the rule resulted in an estimated increase to reported regulatory net worth of $2.2 billion -- approximately four percent -- as of that date. Thus, more than $65 billion in deposits were allowed to be accepted and loaned out backed solely by such write-ups. 21/

2. Loan Fees

Beginning in 1979, thrifts were allowed to recognize income from construction loan fees for RAP purposes on a basis that was more liberal than

---

19/ FHLBB, "Amendments to Net Worth and Statutory Reserve Requirements," 47 Fed. Reg. 52,961 (1982).

20/ FHLBB, "Appraised Equity Capital," 50 Fed. Reg. 45,988 (1985).

21/ R. Brumbaugh, Thrifts Under Siege: Restoring Order to American Banking (1988) at 44. These calculations are based on data supplied by the FHLBB.

permitted by GAAP. Thrifts were allowed to recognize income from loan fees equal to 2.5 percent of the loan amount, plus $400, immediately upon origination of a loan. Thus, for a $20 million construction loan, RAP would allow a thrift to record $500,400 in loan fee income [($20 million x .025) + $400] on the day of closing. In contrast, GAAP allows immediate recognition of loan fee income only to the extent of costs incurred in originating loans, which in this example might reasonably have been $100,000. The remainder of the fees are taken into income ratably over the life of the loan if it remains current, or upon sale. The earnings for RAP purposes arising from loan fees were greatest for those thrifts with significant construction loan volume. This almost certainly induced many institutions to enter into additional construction loans (however risky) in order to generate immediate income. A thrift making $1 billion per year in new construction loans, for example, could report $25 million per year in income from loan origination fees, even though the loans might be extraordinarily speculative and ultimately might never be repaid.

3. Loan Loss Deferrals

As noted above, many thrifts maintained large portfolios of low-interest, long-term mortgage loans that, in the high-interest rate environment of the early 1980s, could be sold only at a substantial discount from their face amount. Both GAAP and RAP allowed such portfolios to be carried at cost, without reflecting the dramatic and very real loss in market value that had occurred. However, if any

such mortgage loan was sold (such as to a secondary mortgage agency), GAAP required the full amount of the actual loss to be recognized. 22/

To encourage portfolio restructuring, the FHLBB issued regulations in 1981 that allowed thrifts to book the entire amount of a loss on sale as an asset for RAP purposes. Thrifts could then amortize the losses realized on the sale of such loans over the remaining contractual life of the assets sold. For example, a thrift that sold a $500 million face amount of mortgages and incurred a loss of $150 million could treat this accumulated and realized loss as an asset included in net worth. The thrift could, as a result of the accounting entry, maintain its current level of activity without injecting new capital, notwithstanding a $150 million reduction in the real value of the enterprise.

The deferral of losses on assets sold created a major divergence between GAAP and RAP measures of net worth. Deferred losses exceeded $6.3 billion, or 13 percent of reported regulatory net worth, as of December 31, 1985. At then-applicable capital levels, this $6.3 billion in losses was all the capital required to continue to support $207.9 billion in loans.

The option to defer losses on assets sold encouraged thrifts to incur more risk. Since thrifts could book 2.5 percent loan origination fees as income immediately, many thrifts reported substantial profits from relending the proceeds from the sale of old loans that created losses that would not be fully recognized for

---

22/ As discussed in the last section of this testimony, the use of mark-to-market accounting would eliminate this incentive to hold assets that can be sold only at a discount from book value.

as long as 30 years. Thrifts also received tax benefits from the sale of old loans, since the sales resulted in realized losses for tax purposes.

C. Accounting Interpretations

1. Purchase and Goodwill Accounting

In the early 1980s, the FHLBB encouraged and facilitated the sale of financially troubled and insolvent thrifts to healthier institutions. As part of many such transactions, the staff of the FHLBB permitted accounting techniques with respect to the treatment of goodwill that made the acquisition of troubled thrifts more attractive.

The "buyer" in such transactions often put up little or no cash because the institution being acquired had little real value. Indeed, in many cases, the buyer assumed the assets and liabilities of an institution with a significant negative value. The assets of these troubled thrifts (mostly long-term mortgages) had, for the most part, depreciated in value as a result of changes in interest rates. In accordance with GAAP, they were recorded on the buyer's books at fair market value. The "discount," or difference between the original book value and the fair market value, was booked as income over the estimated life of the assets on an interest-method basis. The net liabilities (i.e., the fair value of total liabilities less the fair value of the assets acquired) were recorded as goodwill and expensed on a straight-line basis over an amortization period.

GAAP recognize that there is considerable judgment to be applied in determining the appropriate amortization period for goodwill, specifying only that

the goodwill be amortized over the period benefited, not to exceed 40 years. Many thrifts were permitted by thrift regulators to use the maximum 40-year period, resulting in a yearly "expense" for goodwill of one-fortieth of the total amount. Because the typical life of the purchased assets averaged about 10 years, however, this meant that the "discount" was recorded as income over a shorter period. Thus, during the first 10 years after the acquisition, the income from amortizing the purchase discount would exceed the expense from goodwill, generating net income for the acquiring thrift. 23/

From 1974 to 1981, FHLBB guidance required thrifts to amortize goodwill over no more than 10 years. 24/ In August 1981, the FHLBB directed its staff to eliminate this restriction on acceptable goodwill amortization periods, with the result that some thrifts indiscriminately used the 40-year maximum amortization

---

23/ The impact of this provision can be seen in the treatment of an acquisition of a troubled thrift whose assets had lost $1 billion in actual value from a face amount of $3 billion, due to an increase in interest rates. In this circumstance, a buyer that assumed the net assets would have recorded liabilities of $3 billion, loans of $2 billion and goodwill of $1 billion. Absent payment defaults, in subsequent years the loan balance would be gradually increased to correspond to the principal payments of $3 billion. These increases would result directly in additions to interest income of $1 billion. Assuming the loans have an average estimated maturity of ten years, and that the income is recognized on a straight-line basis, income will be increased by $100 million in the first year solely as a result of this amortization practice. Assuming the goodwill is amortized over 40 years, the goodwill expense will be $25 million in the first year, resulting in a net increase to net worth of $75 million (before tax) after one year and $750 million after 10 years. Further, since GAAP requires amortization of loan discount using the interest method, the enhancement of income in the earlier years is amplified.

24/ FHLBB Memorandum R-31a (March 8, 1974).

period allowed by GAAP. 25/ While this accounting treatment purportedly was based on GAAP, the SEC refused to allow thrift holding companies reporting to the Commission to amortize goodwill over a period longer than 25 years. Shorter periods were required when the transaction involved a troubled institution. 26/ The ability to extend the amortization of goodwill had the effect of increasing the apparent profitability of acquiring institutions, as well as increasing the overall capital of the thrift industry by eliminating the capital shortage of the insolvent thrifts.

25/ See FHLBB, "Treatment of Goodwill Acquired in Mergers," 46 Fed. Reg. 42,274 (1981). The FHLBB had earlier proposed to adopt a regulation codifying the guidance in Memorandum R-31a, stating that "[t]he use of different accounting periods in this instance may give rise to distortions in net worth levels and computations." 45 Fed. Reg. 72,661, 72,662 (1980).

26/ This position was embodied in Staff Accounting Bulletin ("SAB") No. 42, an interpretative release issued in 1981. The FASB ultimately adopted the general concepts of this interpretive position as an industry-specific GAAP, FAS No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, issued in February, 1983. FAS No. 72 requires that goodwill, to the extent that it results from the assumption of excess liabilities, be amortized on an interest method over the life of the interest bearing assets acquired. It also requires that regulatory assistance be netted against goodwill.

SAB No. 42A was issued in December 1985 to deal with issues relating to the formation of thrift holding companies that become Commission registrants. This SAB indicated that the use by such companies of the long goodwill amortization periods permitted in their filings with the FHLBB would not be acceptable in Commission filings. It further noted concerns with the use in Commission filings of purchase accounting (with 40-year goodwill) for mergers of failing institutions.

The change in accounting standards for goodwill created purely imaginary earnings and net worth for regulatory purposes. In 1982 alone, over $15 billion in goodwill was created in purchase transactions, thereby enabling thrifts to maintain approximately $500 billion in deposits and to make an equivalent volume of loans without a single dollar of tangible capital investment. In that year, goodwill as a percentage of total industry GAAP capital rose from six percent to approximately 82 percent. 27/

The dramatic effects of these accounting techniques on the capitalization and discounting of goodwill in the presentation of thrift capital can be seen in Chart 6.

The extended period for amortization of goodwill coupled with the 10-year booking of acquisition discount as earnings, as Chart 7 shows, also produced a distorted and misleading picture of income.

In some instances, specific types of transactions were structured to take advantage of these and similar measures. As the number of insolvent thrifts expanded rapidly in certain areas of the country, thrift regulators had difficulty soliciting financially sound buyers. In what were referred to as "Phoenix" transactions, the regulators would select several thrifts, which were usually all

---

27/ W.K. Black, Ending Our Forbearers' Forbearance: FIRREA and Supervisory Goodwill, Stan. L. & Pol'y. Rev. (Spr. 1990) 100, 106 (citing R. Brumbaugh, supra, note 21 at 40-41, 50). The figures provided include all industry goodwill, and are not limited to goodwill affected by the techniques described above. However, it has been estimated that as much as 90 percent of aggregate thrift goodwill was related to such "supervisory acquisitions."

insolvent, and designate one of the insolvent thrifts as the purchaser of the others. By applying purchase accounting and goodwill concepts, the new, but still economically insolvent, thrift formed by the combination immediately generated reported profits. The shorter amortization period applied to the discount on purchased assets relative to that which applied to the corresponding goodwill resulted in a substantial artificial inflation of earnings. 28/

2. Acquisition, Development and Construction Lending Loans

During the 1980s, financial institutions, especially thrifts, engaged in types of transactions involving the funding of real estate development that were

---

28/ As a result of the passage of FIRREA, existing capital standards were required to become not less stringent than those utilized for national banks. In addition, FIRREA mandates an additional capital test by requiring that, irrespective of the level of GAAP capital, a thrift must also have a minimum level of capital excluding computation of goodwill and other non-tangible items. This provision is vital to insuring that thrift operators must have their own funds at risk in their operations, and that all new deposits and loans must be backed by a minimum amount of tangible capital, not simply goodwill or other intangibles. The Office of Thrift Supervision ("OTS") recently has attempted to withdraw permission for thrifts to use long goodwill periods for RAP purposes. This transitional rule provided for the phase-out of the use of supervisory goodwill for purposes of calculating "core capital" by December 31, 1994. In a few cases, lower courts have allowed thrifts to continue to recognize supervisory goodwill because these institutions had received FHLBB staff "forbearance letters" authorizing the longer period of goodwill prior to the enactment of FIRREA. Even though such promises were often made by the staff, and were not voted on by the FHLBB itself, at least two lower courts have held that the letters are binding notwithstanding the provisions of FIRREA. See, e.g., Winstar Corp. v. U. S., No. 90-8C (Ct. Cl. July 27, 1990) (35-year goodwill amortization period upheld), and Franklin Federal Savings Bank v. OTS, CIV-2-90-166 (D. Tenn., July 16, 1990). The excesses permitted in this area, therefore, continue to affect the industry.

mischaracterized as lending activity. Acquisition, development, and construction ("ADC") loans typically were structured so as to give the financial institution the risks and rewards of investor participation rather than the lender's normal principal and market rate of interest payment arrangement.

GAAP require that accounting treatments reflect the substance of transactions rather than their form. By improperly characterizing these transactions as "loans," financial institutions were able to inflate their income. For example, on a $10 million mortgage at 12 percent that was legitimately structured as a loan, the lender would normally recognize interest income of at least $1.2 million per year. 29/ However, if the transaction were structured so that the lender (and not the borrower) had significant capital at risk, interest accrual would not be appropriate because the transaction would be accounted for as a joint venture transaction. 30/

To assist institutions and auditors in evaluating the substance of ADC transactions, the AICPA published a series of guidelines beginning in 1983. 31/

29/ As noted earlier, RAP treatment of loan fees resulted in substantial additional income in the period that the loan was made.

30/ Where the transaction is accounted for as a joint venture, the financial institution might be able to capitalize the interest payment, which would increase the carrying amount of the asset. The benefit to the financial institution of this accounting treatment, however, would be less than the benefit of including interest income.

31/ See, e.g., Notice to Practitioners, "Certain Real Estate Lending Activities of Financial Institutions" (November 1983); Notice to Practitioners, "ADC Loans" (November 1984). In February 1986, the AICPA issued new and expanded guidance (continued...)

In October 1984, the FHLBB proposed to adopt a statement of policy concerning the regulatory accounting for certain real estate activities. 32/ This policy, which was intended to be consistent with the AICPA's guidelines, was not adopted until April 1985, and was applicable only to transactions occurring after that date.33/

ADC loans proved to be a major problem area, as thrifts suffered large losses from high risk investments improperly accounted for as loans. Given the judgmental nature of the accounting requirements in this area, and the temptation to report investments as loans (thereby obtaining up-front fee income and accelerated recognition of interest), unequivocal guidance and strict enforcement by the FHLBB were necessary, but did not occur in many cases.

3. Repurchase Transactions

During the mid-1980s, some financial institutions engaged in certain speculative forward commitment transactions, known as "dollar-rolls," that were

---

31/(...continued)
which encompassed the earlier notices. Notice to Practitioners, "ADC Arrangements" (November 1986). The guidance was generally consistent with how the Commission staff applied the accounting literature.

32/ 49 Fed. Reg. 43,557 (1984).

33/ FHLBB, "Statement of Policy, Accounting for Acquisition, Development and Construction Loans," 50 Fed. Reg. 18,233 (1985). The adopting release stated that "classification of ADC transactions is best left to the insured institution and its independent public accountant," and indicated that examiners would review the institution's documentation of its decisions and that supervisory agents would review any examiner's concern and discuss them with the institution. 50 Fed. Reg. at 18,235 (1985).

accounted for as borrowing/lending (financing) arrangements. The effect of accounting for these transactions as financing was to defer loss (or gain) recognition.

The most significant example of this practice was that engaged in by Financial Corporation of America ("FCA"), a public holding company. Reports filed with the Commission showed that, as of June 30, 1983, FCA had total assets and stockholders' equity of $10.7 billion and $219 million, respectively. During the third quarter of 1983, three significant factors affected FCA's size and operations: American Savings & Loan Association was acquired, which approximately doubled FCA's asset base; FCA initiated a program of purchases of securities financed by repurchase agreements; and FCA aggressively sought increased deposits, including brokered deposits. By September 1984, 13 months after the American S&L acquisition, FCA's assets had more than tripled to $32.4 billion and repurchase obligations, which had been non-existent in June 1983, had risen to $7 billion, or approximately 22 percent of total assets.

In mid-1984, the Commission's staff determined that FCA's investment and repurchase transactions were, in substance, forward commitments to purchase securities. Since GAAP preclude accounting for such transactions as leveraged investments and recognize that these are speculative transactions, mark-to-market accounting is required for these commitments. The application of mark-to-market resulted in restatement of FCA's financial statements, including recognition of a loss of $155 million on these transactions. Further, following the loss recognition,

FCA experienced serious liquidity problems, including a single quarter withdrawal of deposits of $6.84 billion. Ultimately, FCA became insolvent, and resulted in a loss to the public of billions of dollars.

The foregoing is not, of course, a complete survey of all the differences between RAP and GAAP for both banks and thrifts. In some cases, the bank regulators (and post-FIRREA the OTS) have adopted principles that are more conservative than GAAP. However, in order to make sure that RAP might not be utilized in the future to weaken accounting principles and to conceal financial problems, we should consider other long-range improvements to accounting by financial institutions.

III. THE PROPER ROLE OF FINANCIAL REPORTING: MARKET BASED ACCOUNTING

The Committee's last question focuses on a matter that is also a major area of current Commission concern: the valuation of financial instruments held by financial institutions. Under current practice, GAAP for banks and thrifts are based principally on a historical cost framework. These institutions are permitted to carry assets on their books at amortized cost, even in instances where the current value of the assets has eroded substantially, and where a market-based standard would provide a far more accurate measure of the institution's financial health.

As we enter the decade of the 1990s, we should consider a fundamental shift in the goal we set for the accounting standards for financial institutions. Financial institutions are in the business of buying and selling financial

instruments, all of which have a value measured in terms of current market conditions. Determining the current value of an institution's assets, not recording their original cost, should increasingly be the goal toward which we must work.

The bedrock for current general-purpose financial reporting for almost all industries is the "historical" cost model. 34/ In most cases, historical cost produces reliable information because it is based on verifiable recorded amounts for transactions. However, as many observers have noted, the cost system has been subject to abuses and can lose its relevance in a changing economic environment, such as that experienced by the thrift and banking industries in the 1980s. As observed by Edward J. Kane, using historical cost undervalues an institution's best portfolio decisions and overvalues its worst ones. Worse, by not modifying carrying values to reflect subsequent market developments, irrefutable and often readily observed evidence is neglected. 35/

The nation's experience with the crisis in the savings and loan industry, as well as many of the largest bank failures, demonstrates the inherent and

---

34/ Under the historical cost model, most assets are recorded at their acquisition price, which is presumed to be more objective. Departing from the historical cost rule (i.e., using the lower of cost or market, or "LOCOM") is generally done only when the future utility (or revenue-producing ability) of an asset is less than its cost. Such differences should be recorded in the period in which they occur. (See, e.g., Financial Accounting Standards Board Statement of Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," (December 1984), paragraphs 67-69; Accounting Principles Board, "Accounting Research Bulletin No. 43," Chapter 4, paragraphs 8 and 9.)

35/ E. Kane, supra note 3, at 31.

substantial dangers of a reporting system for financial-institutions that is premised on historical cost accounting principles. Market-based information can permit regulators and investors alike to make a much more meaningful assessment of the real economic value and risk exposures of a financial institution. Knowing current market value also allows regulators to take appropriate actions before a situation deteriorates irretrievably.

When a financial institution becomes insolvent, the loss to the insurance fund, and ultimately to the taxpayers, is measurable based solely on the market values of its assets and liabilities -- historical costs are irrelevant. The risk exposure to the insurance system should therefore be calculated on the same basis that its ultimate obligation will be calculated. Although market values perhaps cannot be measured with the same degree of precision as historical costs, it has been appropriately noted that the best possible estimate of a relevant concept is better than a precise measure of an irrelevant one. 36/

While some have argued that mark-to-market accounting would produce unacceptable volatility in operating results, and other problems, market-based accounting has long been required of broker-dealers and investment companies. Thus, firms like Salomon Brothers, Merrill Lynch and others with huge securities positions routinely use daily mark-to-market accounting without such problems. So too, mutual funds with hundreds of billions in securities report must utilize mark-to-market accounting. It is therefore questionable whether this method of

---

36/ The Brookings Institution, "Blueprint for Restructuring America's Financial Institutions" (1989).

reporting by banks and thrifts would produce any significant problems -- especially as to their holdings of securities irrespective of "trading" or "investment" intent.

The Commission recognizes that transforming the accounting standards of banks and thrifts from a cost to a market-based standard is a complex undertaking, and we realize that studies are currently under way concerning these issues. 37/ The objective of these efforts should be to achieve financial reporting that uses appropriate market-based measures of valuation at the earliest possible date.

A. Trading Versus Investment

The Committee's question focuses on one aspect of the cost-based/market-based accounting issue: the accounting treatment that should be accorded to debt securities held by a financial institution. Presently, banks and thrifts report debt securities classified as trading assets at market prices. Securities classified as investments are carried at cost (less provisions for credit losses), or at the lower of

---

37/ Several studies are currently under way concerning these issues. The FASB has a significant project addressing the accounting for financial instruments, which encompasses the issue of market-based measures. The FASB currently is focusing on disclosure of value information. In addition, the International Accounting Standards Committee and the Canadian Institute of Chartered Accountants have a similar joint project which is in the early stages. Both projects involve consideration of value-based accounting and disclosure. As part of the study of the Federal deposit insurance system required by section 1001 of FIRREA, the Department of the Treasury, in consultation with the federal banking agencies and others, is to evaluate several topics, including the feasibility of market value accounting. See FIRREA, Section 1001(b)(4).

cost or market if the institution does not have either the intent or the ability to hold the securities. 38/

Under current GAAP, recording investment securities at cost generally requires that an institution have the ability and intent to hold the securities to maturity. 39/ The rationale for this treatment is that, if the security is held to maturity, it will be redeemed at its face amount. Therefore, temporary fluctuations in market value due to interest rates changes are considered irrelevant since they do not affect ultimate realization. 40/ This justification is irrelevant, however, to the value of the investment, and to the true value of rate of return in an institution's portfolio. Even if the principal of a debt security is ultimately paid 29 years in the future, this does not eliminate the relevance of a

---

38/ In most other major countries, trading accounts are generally carried at market; however, Germany and Japan generally use LOCOM. For non-trading debt investments, the accounting is generally at cost or LOCOM -- Japan and Germany use LOCOM, Canada uses principally cost, while certain other countries (e.g., the United Kingdom and France) distinguish among cost, LOCOM, or market based on the purpose of the investment.

39/ Under existing accounting rules, when the institution does not have the ability to hold the instruments to maturity, market losses must be recognized. Thus, the passage of FIRREA, which required thrifts to dispose of junk bonds and other risky investments, forced the recognition of significant market losses that had occurred as a result of a declining value of these speculative investments. If the thrift regulators had used market-based measures to assess the capital requirements of thrifts during the last decade, it would have been clear that some of these institutions did not have the ability to hold these investments to maturity.

40/ AICPA Industry Audit Guide, "Audits of Banks," 30 (2d ed. 1984).

significant decline in the return on the true value of that security during the intervening years.

This accounting rule was developed in a vastly different economic environment than the one in which institutions must function today. Today financial institutions actively manage their interest earning asset and interest bearing liability portfolios to maximize net income and to manage interest rate risk. This "asset/liability" management often requires frequent buying and selling of investment securities to restructure asset and liability maturities. The continued use of the historical cost model in this environment is inappropriate because of the diminished relevance of the resulting financial information.

Further, the continued use of historical cost accounting for investment securities has enabled institutions to "manage" the timing of gains and losses. Some thrifts did trade out of their so-called investment portfolios, but only when doing so allowed recognition of a gain. "Gains trading", i.e., selling profitable positions and holding losing positions, also referred to as "cherry picking," had the effect of inflating the thrift's apparent short-term profitability while inevitably leading to declines in future yields.

In the late 1980s, just before the passage of FIRREA, the FHLBB finally sought to curtail gains trading through the adoption of regulatory accounting guidance. 41/ However, the guidance was controversial and complex, and OTS

41/ 12 C.F.R. 563c.102 (effectiveness delayed until April 1, 1990 by 55 Fed. Reg. 126 (1990)).

subsequently deferred implementation of this guidance to permit the AICPA to clarify the principles and to develop guidance for banks as well as thrifts.

In the interim, the Commission's staff has acted to enhance the information provided in filings with the Commission. Financial institutions filing with the Commission must consider the need to furnish the amount of gross unrealized gain and loss in the investment portfolio, and are required to provide a description of the accounting policies followed in reporting its investment portfolio, and an analysis of any material effect on future earnings from unrealized portfolio losses and portfolio sales. In appropriate circumstances, failure to disclose such items will result in enforcement action by the Commission. The staff will continue its current practice of carefully considering the adequacy of disclosures made by financial institutions. The Commission's staff has also encouraged the AICPA to provide accounting and disclosure guidance applicable to both banks and thrifts in order to avoid conflicting accounting requirements among financial institutions. 42/

In May 1990, the AICPA published for comment proposed rules intended to provide practical guidelines for evaluating the intent and ability of an entity to hold securities to maturity. 43/ Under the proposal, trading securities would

---

42/ See Letter of December 20, 1989 from Mr. Edmund Coulson, the Commission's Chief Accountant, to Mr. Jack Kreischer, Chairman of the Accounting Standards Executive Committee of the AICPA.

43/ AICPA Exposure Draft of Proposed Statement of Position, "Reporting by Financial Institutions of Debt Securities Held as Assets" (May 25, 1990). The proposal would apply to (continued...)

continue to be marked to market. Other debt securities in the investment portfolio would be carried at cost if the institution has the current ability to hold to maturity and the intent to hold for the foreseeable future (which is arbitrarily defined as one year). However, if it reasonably is expected that the institution would sell debt securities in response to probable events in the foreseeable future, including interest rate changes, the securities would be classified as held for sale and carried at the lower of cost or market. A substantial number of comments have been received on the proposal, and most have criticized it as unworkable.44/ Indeed, many of the commentators suggest that the proposal would not result in consistent reporting and would not deal with abuses such as gains trading.

The Commission will carefully oversee the AICPA's deliberations on this issue to ensure a sound and effective proposal. The constraints on the AICPA committee to remain within the framework of existing formal accounting literature may lead only to an interim resolution of this issue. However, because it is inherently difficult to distinguish portfolio categories based on intent and ability, particularly considering the dynamic market environment in which investment

---

43/(...continued)
banks, thrifts, financial companies, insurance companies and credit unions.

44/ Of course, major securities firms are already required to mark their often enormous portfolios to market on a daily basis.

decisions are made, serious consideration must be given to reporting all investment securities at market value.

B. Additional Market-Based Measures

Steps currently being taken to clarify the accounting treatment for investment portfolios should be part of a broader move in the direction of mark-to-market accounting. The benefits of market-based accounting warrant consideration of a broader shift in this direction. The presumption that market-based information is the most relevant financial data attribute should be recognized. It may be appropriate to utilize historical cost only where specifically justified by the circumstances in the future.

The Commission recognizes that the move to a full-scale application of market-based accounting requires careful and deliberate planning. The Commission is aware that strong views are held and valid concerns exist concerning a shift to market value accounting. In particular, great care must be taken to ensure that the costs of implementation and ongoing compliance do not exceed the expected benefits. With respect to reliability of market value information, additional work will be necessary to develop reasonable and cost-effective valuation techniques for those assets and liabilities that do not have a liquid market. 45/ We need to explore ways to reduce subjectivity of estimates to an acceptable level. The Commission does not underestimate the significance or

---

45/ Valuations are used by well managed institutions in making business decisions and are applied routinely in business combinations.

importance of these and other issues. However, we believe that their resolution must be aggressively pursued.

IV. CONCLUSION

The thrift crisis confirms that effective regulation of financial institutions requires adherence to sound accounting principles. It is essential, for the purposes of both general financial reporting and regulatory reporting, that financial institutions adhere to accounting standards that result in an accurate portrayal of the institution's financial position and results of operation.

The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to a fair and accurate presentation, they fail in their purpose. This may also become the camouflage for improper and unsafe practices. Because of these dangers, all publicly-held companies, including financial institutions, should be required to adhere to a uniform set of accounting principles. The principles should be established through a standard-setting and review process, overseen by a single agency, that is immune to tampering by a failed industry or its regulators. The value of uniform standards will be enhanced if, wherever possible, they are based on market-based measures of valuation.

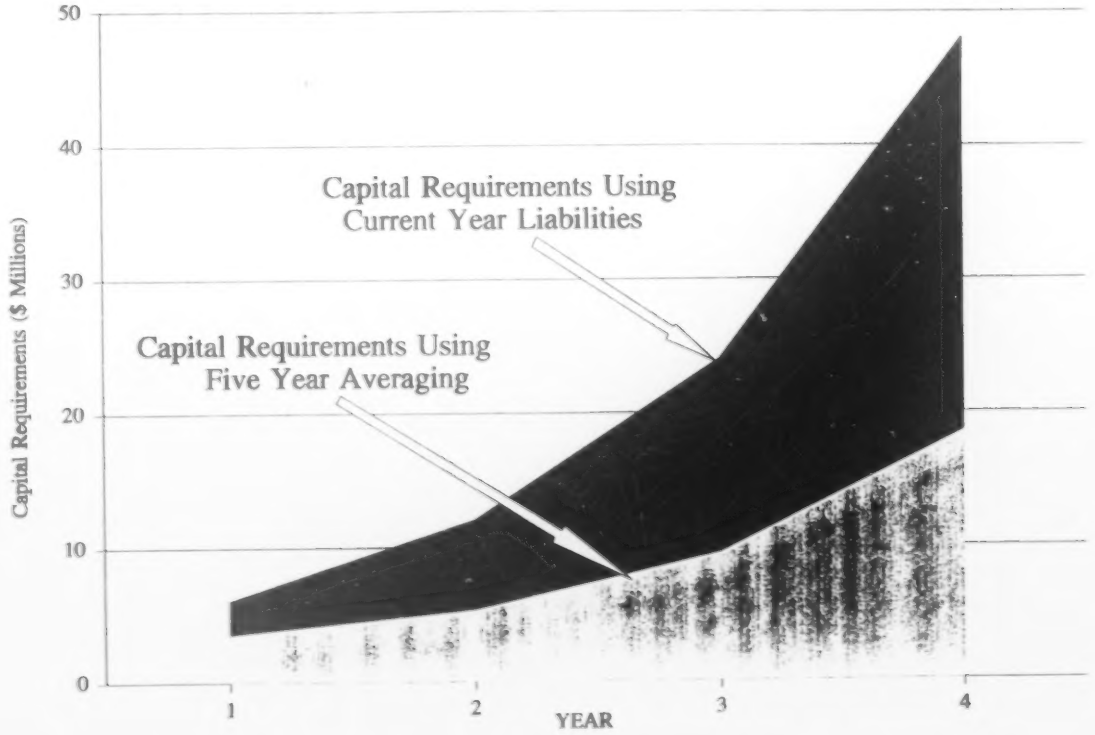
We must learn from our experience in the thrift crises as we develop today's disclosure standards. Although accounting techniques were used to enhance the perception that thrift institutions were operating on a safe and sound basis, they

did not -- and could not -- make any thrift institution more safe or sound in fact. Changes in accounting standards do not change the underlying business reality. They may, however, alter the way that we perceive and measure that reality. It is therefore especially important that appropriate uniform standards be adopted in order to ensure that the heightened capital adequacy standards established by FIRREA will be effective, and that we seek to become aware of insolvency or financial crisis at the earliest possible time, not when it is already too late.

CHART NO. 1

Total Assets of FSLIC Insured Institutions
3% Net Worth Rule
Loan Diversification
Appraised Equity Capital
Net Worth Certificates
Goodwill to 40 Yrs
Loan Loss Deferrals
Interest Rate Deregulation
4% Net Worth Rule
$100,000 Deposit Insurance
5 Year Averaging
Reg Q Spread = 25 BP
Reg Q Spread = 50 BP
Reg Q for Thrifts
Assets (Billions)
1500
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
1960
1961
1962
1963
1964
1965
1966
1967
1968
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990

CHART NO. 2



Assumes a hypothetical thrift with liabilities of $94 million in year -3, $96 million in year -2, $98 million in year -1, $100 million in year 0, $200 million in year 1, $400 million in year 2, $800 million in year 3 and $1.6 billion in year 4. Hence, this thrift has relatively static growth in years -3 to 0, and 100% growth in years 1 to 4.

CHART NO. 3

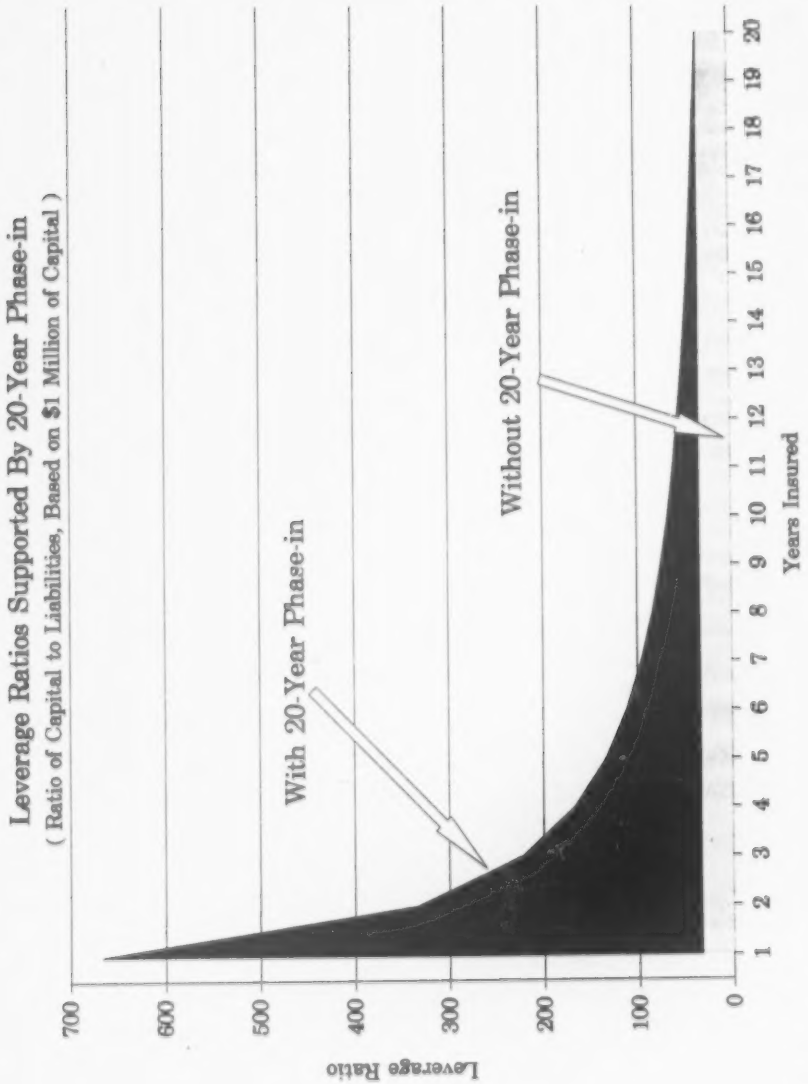

Leverage Ratios Supported By 20-Year Phase-in
(Ratio of Capital to Liabilities, Based on $1 Million of Capital)
With 20-Year Phase-in
Without 20-Year Phase-in
Leverage Ratio
700
600
500
400
300
200
100
0
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20
Years Insured

CHART NO. 4

Total Assets and TAP Capital
of FSLIC-Insured Institutions, 1980-1989
TAP Capital
ASSETS
TAP Capital ($ Billions)
Assets ($ Trillions)
34
32
30
28
26
24
22
20
18
16
14
12
10
8
6
4
2
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989

Number of Insolvent Thrifts Based On RAP and GAAP Capital Requirements

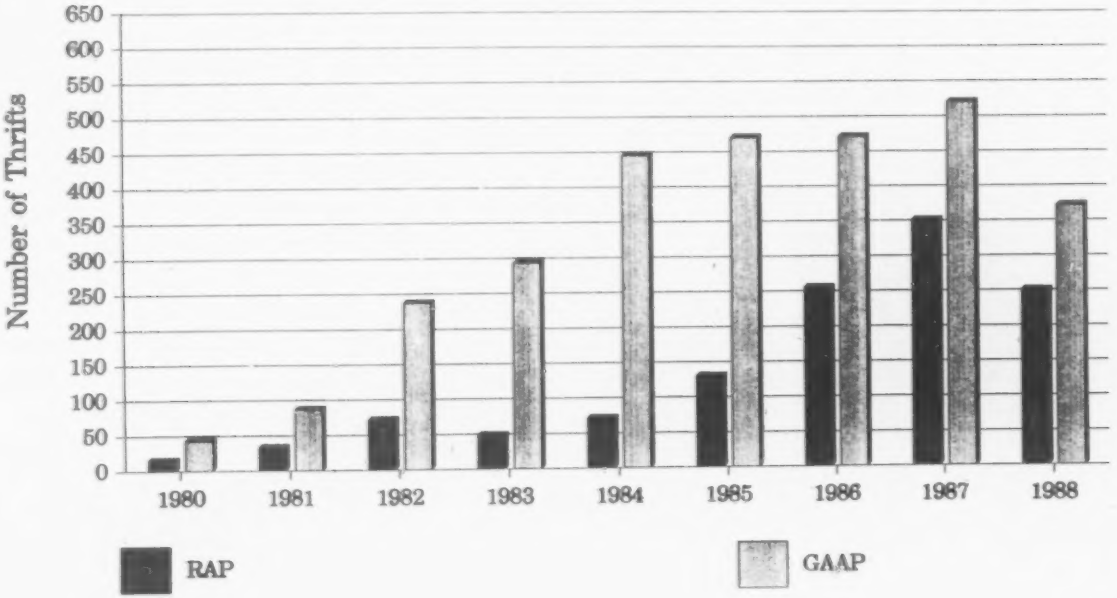


CHART NO. 5

CHART NO. 6

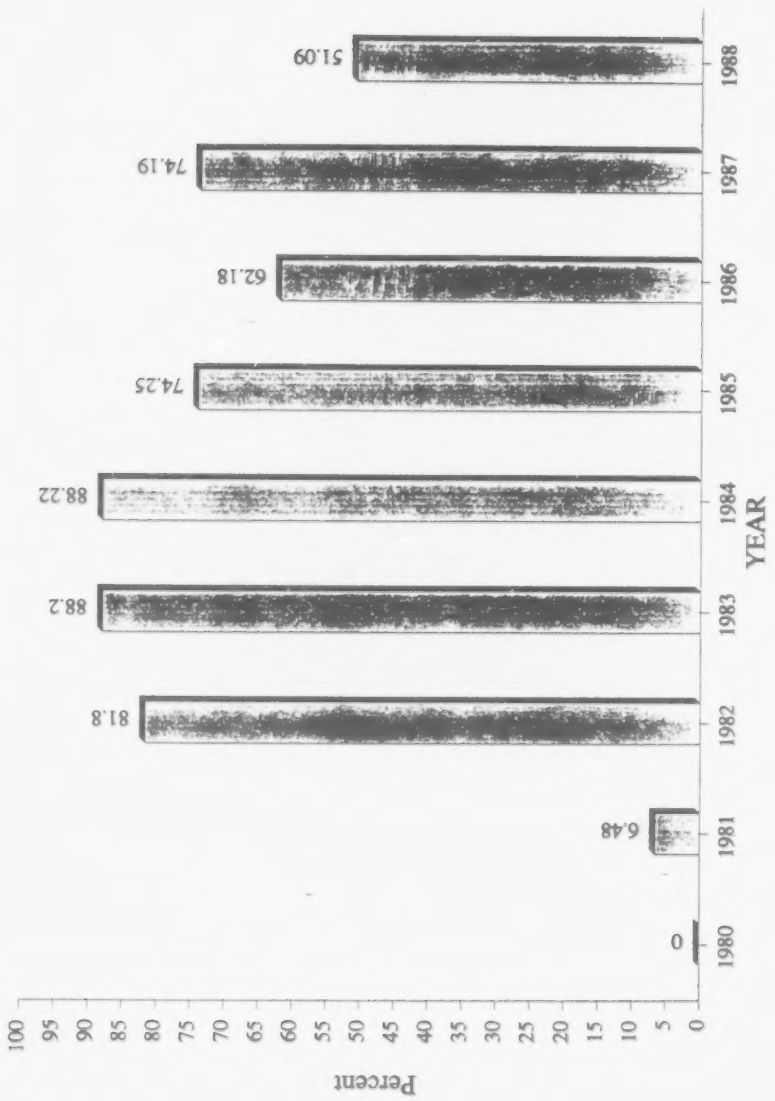
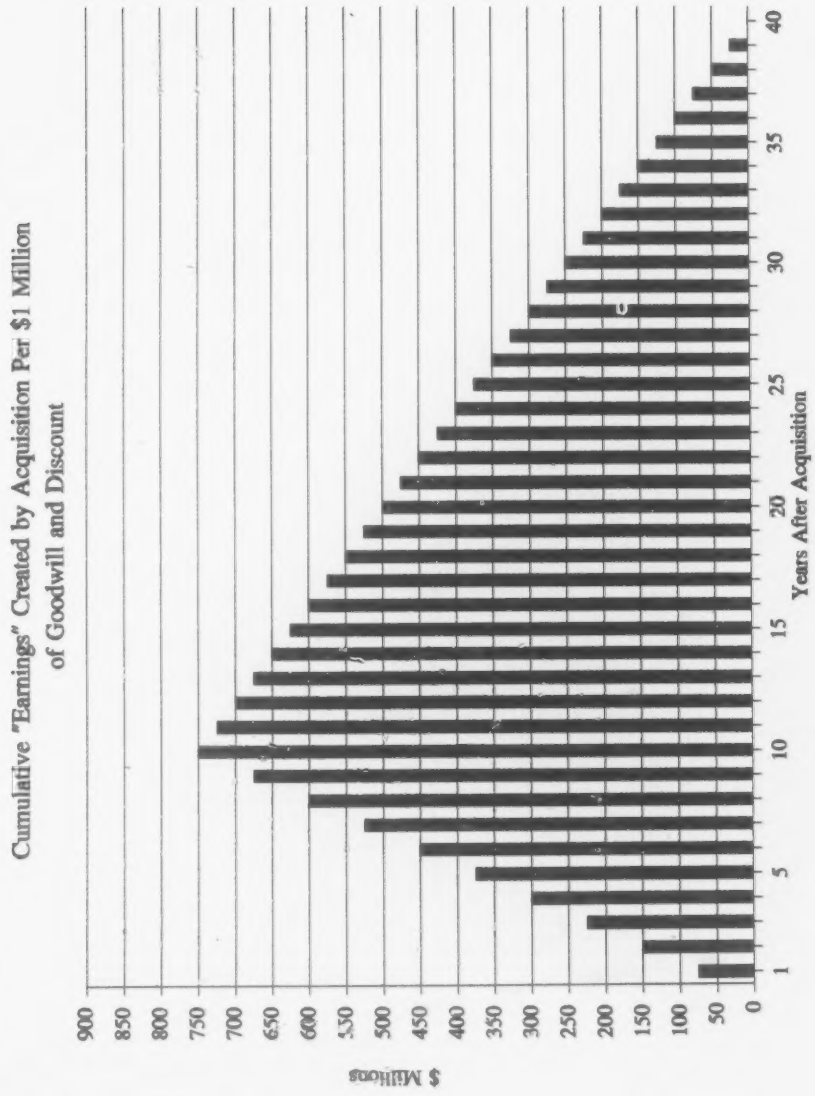

Goodwill as a Percent of GAAP Capital
for FSLIC Insured Institutions
Percent
100
95
90
85
80
75
70
65
60
55
50
45
40
35
30
25
20
15
10
5
0
0
6.48
81.8
88.2
88.22
74.25
62.18
74.19
51.09
1980
1981
1982
1983
1984
1985
1986
1987
1988
YEAR

CHART NO. 7



Assumes $1 Million in goodwill and discount, with 40-Year write-off of goodwill (2 1/2% per annum) and 10-Year booking of discount (10% per annum).

The CHAIRMAN. Thank you very much for your views today and for your patience in allowing me to engage you at different points in what was a structured presentation that you spent some time in preparing for the committee.

Let me just take you through briefly two or three items here.

In the crime bill that passed the Senate, as you know, there is a provision that called for open enforcement hearings and publication of all types of enforcement orders for banks and for thrifts.

Now the bank regulators generally respond that they have to do their enforcement work in secret or else the public will panic and there will be runs on those financial institutions, and I'm just wondering what you think of that argument?

Chairman BREEDEN. I think public disclosure is one of the greatest disinfectants ever invented. We disclose every enforcement action against a broker dealer firm or against an individual even if it amounts to only $100 in value, and I think that is an excellent policy.

I generally think historically it's true that for bank regulators there has been an attitude and an approach to problems that we shouldn't worry the public and we should try and resolve these matters confidentially. But I think we have probably erred too much on the side of keeping confidential matters that investors and the public should be entitled to know about and that have a great deterrent effect when they are disclosed, and that we should make more use of the disclosure of these matters.

The CHAIRMAN. I agree with you. My inclination runs along those same lines. I think there is a real disinfectant power to that, and I also think it creates an incentive for people I think to be quite careful. I think it's one thing if you know that you not only face an enforcement action, but you're going to face it in the full light of day, and I think it would have a beneficial effect on conduct before the fact, but I appreciate your view on that.

Let me ask you this. In 1987 here in this committee I was serving as chairman of the Securities Subcommittee, and we issued a report at that time that accompanied the authorization for the SEC bill, and this would have been January 1987, and in the report we said this:

> The surge in well-publicized instances of fraudulent activities by persons associated with savings and loan and other financial institutions raise serious questions. An enhanced governmental enforcement presence is clearly warranted. The subcommittee requests that the SEC in coordination with the various interested bank regulatory agencies promptly address this serious issue.

Can you tell us, and you were not there at that time, but you are there now, and can you tell the committee what the SEC has been doing in that respect under your stewardship since you've taken over?

Chairman BREEDEN. This is to coordinate with the bank regulators?

The CHAIRMAN. To coordinate with the bank regulators and to crack down on clearly the pattern that was emerging at that time and was I think there to be seen.

Chairman BREEDEN. Well, shortly after I became chairman I did create within our Enforcement Division a special task force to review matters relating to filings by depository institutions, banks,

and thrifts. We created a similar unit within our Corporation Finance Division that reviews the securities filings we were talking about earlier. Both of these efforts were taken to try and improve the speed and effectiveness of our own oversight as to bank and thrift holding companies and the financial reporting and securities disclosure practices that they may have followed.

I wouldn't want to suggest that these institutions have not been complying with the law, but, as we were discussing in our colloquy earlier, there are a number of unique accounting principles, for example, that are followed in these institutions. I thought we should have a dedicated group of people who are familiar with them rather than having the review of these filings occur randomly throughout the staff. As a management technique we wanted to try and have a group of people who were fully literate in those practices so they would be as capable as possible in reviewing those specific filings on the corporation finance side.

On the enforcement side we have dedicated what for us, and we're a small agency, is a large amount of enforcement resources looking at cases in the bank and thrift industries. I regret to say that we have a fair number of referrals that have been made to that unit and have a fairly healthy number of cases that it is working on quite actively at the moment. I think in the next few months there will be a number of cases that will be brought publicly. I'm not at liberty to discuss them now, but I think we have found certain practices that did not comply with the law and where we will be forced to take action to deal with that.

The CHAIRMAN. Good. I'm glad you're acting on it. Do you need more people?

Chairman BREEDEN. Well, I have watched in the budget deliberations the hiring of literally hundreds of lawyers and other professionals very usefully in the Department of Justice and in the FDIC and RTC and OTS to look at thrift fraud. We have not been part of those special S&L appropriations and special enforcement authorities for personnel, and we have been trying to do this all out of our existing resources. So I'm trying to do absolutely the most I can out of our current budget.

The CHAIRMAN. Well, if you don't have enough, and let's be very blunt about it, I want to see that you have enough. I don't know the problems are of navigating the bureaucracy of OMB and what-have-you, but if you need more people, you must tell us and I'll do everything I can to get the additional people for you.

Chairman BREEDEN. I appreciate that, Senator. In fact, Mr. Chairman, both OMB and the Congress have been generally very good to us. Last year we had a substantial increase in personnel, and OMB has requested an increase again this year.

Unlike our financial regulatory colleagues, unfortunately, our greatest problem is not the personnel ceilings per se, but it's the pay cap limitations that we operate under. We would love to be able to hire a few senior examiners and senior supervisory personnel——

The CHAIRMAN. We have been pushing hard on that.

Chairman BREEDEN [continuing]. From the bank regulatory agencies to use in our proceedings, except we can't afford to hire any of them because they are already making twice what they would

make at the SEC. So that's more of a problem than the absolute numbers. But we are making, I think, good progress, and I certainly will not hesitate to tell you if we think we can use more personnel. At the outset it has been important to get that effort up and running, and as we get it moving forward I think we may find that we can usefully employ additional personnel.

The CHAIRMAN. Well, let us know if that is the case, and I'll do what I can to get it for you. I share your view on the salary caps. As you know, we have been working on that issue.

Finally, earlier this morning, as I know you are aware, the bank regulators gave their view on forbearance or delayed closure, and we have talked some about that for banks or thrifts that are undercapitalized but still solvent, and I'm just wondering what your views are on delayed closure?

Chairman BREEDEN. Let me first indicate that the Commission, as you know, comes out of a somewhat different structure and background. We do not have a deposit insurance program. The obligations, and in many cases enormous obligations, of broker dealer firms and their parent organizations are not guaranteed by the public, and we do not believe they should be guaranteed by the public. I would be very concerned if any structural change to allow banks broader participation in the securities industry extended the public safety net into the securities industry. I don't think the public ought to be asked to back up the activities of individuals or firms in the securities world.

When we confronted a very large failure, certainly as large as many of the bank failures, in the case of Drexell earlier this year, a $28 billion firm, we were not willing to see the creation for the first time of a safety net through the extension of public funds to such a firm. Drexell was forced to use the bankruptcy courts. The ultimate closure of that firm has, to date, not cost the American public a dollar other than the normal salary of the SEC personnel who might be following it. A very, very large institution, one of the 10 largest securities firms in the world, was closed at zero cost to the public, and that is, in my judgment, the way it ought to be.

So, we come at these questions from a slightly different perspective. We think people who are uninsured creditors ought to make their own credit decisions, and if they make a mistake on that, then that's their problem and the public shouldn't be asked to pay for it. So, I am not a fan of forbearance, and I'm not a fan of using public credit to extend the time of institutions that can't raise capital anywhere in the world. If no investor anywhere in the world has confidence that a given set of management knows how to handle its problems, then I don't know that the American public ought to be asked to put their credit at risk to support that institution.

So, I have a hard time understanding some of the individual decisions that are made particularly on smaller firms, and as a general philosophy I think forbearance can be a very slippery slope down which to travel. We have a process that operates for the rest of the economy for handling insolvent firms. It's a good one, and we ought to use it more often.

The CHAIRMAN. How closely does the SEC monitor the sufficiency of the SIPC fund or the SIPC insurance system, if you will?

Chairman BREEDEN. Well, we have a relationship with SIPC, and we work with and overall SIPC. As you know, it does not include public funding in the same nature as the depository institutions. We are not by statute even on the Board of SIPC.

The CHAIRMAN. If we wanted to take a look at that, would we ask you to help us, or who should we ask to help us?

Chairman BREEDEN. Well, initially I would suspect that the SIPC personnel themselves would be the logical place. We do work with SIPC, and I would be happy to respond in any way that the committee found desirable.

The CHAIRMAN. Are you convinced as you sit here now that there is plenty of cushion there to protect shareholders out across the country?

Chairman BREEDEN. Well, not to quibble, but I think it's very important that people understand what SIPC is and what it isn't. SIPC does not insure the value of people's investments. It secures individuals against defalcation, against theft of securities that they may have.

The CHAIRMAN. Well, does it not also attempt to insure in a situation where if you had sort of a catastrophic event strike and a securities firm found itself turned upside down very quickly and couldn't pay off its accounts, that wouldn't be fraud. That would simply be an inability to return someone's money. Wouldn't the protection be thought to apply in that case or not?

Chairman BREEDEN. Well, the protection isn't needed in that case because, first of all, a customer's securities are required to be segregated. The firm can't be using a customer's securities.

The CHAIRMAN. I know, but I'm saying they have to have enough money——

Chairman BREEDEN. They're required to be protected.

The CHAIRMAN. Yes, but they've got to have enough money in a bank account at the end of a day to be able to pay those off.

Chairman BREEDEN. Those securities must be segregated and held apart from whatever the firm is doing for its own account and the business it's doing. It cannot merely use the customers' funds and then at the end of the day put them back again. There are requirements that customers' positions be segregated and held aside.

The CHAIRMAN. So the fire walls that are there in that instance, in our view, are sufficient and we don't really need to worry about that?

Chairman BREEDEN. Well, it is very important that the fire walls that exist within a firm prevent the firm essentially from embezzling a customer's securities and using them for its own account. That's terribly important in cases, including, I believe, the recent Stotler case in the futures side, where you have firms that are pressured to begin to invade those segregation requirements. It's very important to stay on top of that and to strike instantly if you find that kind of behavior going on. So, that's one important line of defense that makes it very different than the banking world where your deposit is designed to be lent out by the firm and is not in a segregated account.

I do think that one of the things that ought to be looked at in the course of the banking reforms and deposit insurance reforms would be greater utilization of something like, not necessarily a narrow

bank, but maybe a narrow account where customer funds, like a money market fund, are in specific marketable instruments and are held in a trust and protected the same way we hold customer securities in a securities fund. So that is one very important defense. The other that is absolutely critical, and I know we touched on it earlier, is the fact that every day we mark the securities firms to market so that we don't wake up one morning and find that a firm that was reporting on a cost basis that it had a positive net worth of billions of dollars in fact is insolvent on a true market basis. When a firm starts a slide in the securities world, because of that daily discipline we like to think that we find out about it in time to take the necessary action. So the size of SIPC has to be evaluated not necessarily by comparing it to the size of the banking fund, but in comparison with these other very, very important lines of defense.

The CHAIRMAN. Now with respect to an individual's money held by a securities firm that is for the purpose of investing in securities and securities are held by the firm in the name of the person and so forth, setting that to the side, if you take just a money market account, for example, is there degree to which there is the safeguard there that will ensure the repayment of money that someone might have in a money market account?

Chairman BREEDEN. Well, there on a 100 percent of the assets of the entire fund go into liquid instruments, whether they are Treasury securities or other money market instruments, and those instruments are held in a trust. There is no permitted self-dealing. The fund can't invest in the commercial paper of the sponsoring organization, and it can't even make deposits with a sponsoring organization. So, the customer money is pooled together, put in liquid instruments that can be sold every day and have a fully quoted market value, and they are protected in that trust environment. And, of course, you do not have, as you have in the banking system, a guarantee that $100 will come back as $100. You have a share, a fraction of a fund, in that the value of your share can go up and down.

The CHAIRMAN. But do you think a person that has a money market account in a securities firm thinks that if they put in $1,000 in a money market account that is paying an interest rate that they might put in thousand and they might only get $500 back?

Chairman BREEDEN. I don't think they think that, nor would I want them to think that. In fact, the dollar per share net asset value pricing has never been broken, and while a few——

The CHAIRMAN. I don't want it to be broken either, and I'm not suggesting that it's going to be broken. I just want you to explain for the record, because I think it's important to have it there, exactly what the nature of the protection system is and whether there is or is not insurance there in the event of a catastrophic event that took value away very quickly in large amounts.

Chairman BREEDEN. Well, a money market fund is not insured. There is no Federal insurance, and it is not designed to be backed by that type of guarantee. But all of the funds that customers put into the fund are invested in highly liquid securities that can in

fact be sold if the customer wants to either reduce his investment in the fund or completely withdraw from the fund.

The CHAIRMAN. And on any given day, I mean, you know, just to track it all the way through, if all of the investors in the pool decided to get out on a given day, I mean if things looked awfully bleak and everybody wanted to get out on a given day and the investment company had to liquidate in order to pay off all of the accounts, they are under no obligation, are they, to pay those accounts off dollar for dollar?

Chairman BREEDEN. Well, they do have the ability, Mr. Chairman, to distribute in kind. I mean, the fund could ultimately distribute the securities that it holds, although that has rarely been required of a money market fund.

The CHAIRMAN. Well, I don't know that we've ever had a situation arise. How many hundreds of billions do we presently have in money market funds?

Chairman BREEDEN. In money market funds I think it's about $500 billion.

The CHAIRMAN. So the sheer scale of the amount of money market funds, I gather it has not ever really been appreciably higher than that. We're up near the all time high levels; is that right?

Chairman BREEDEN. Mr. Chairman, just so you know, the person to whom I'm looking and asking is Marianne Smythe, my executive assistant, who is former Deputy Director of our Division of Investment Management and is one of our most outstanding experts on matters of mutual funds and money market funds. I don't know whether you have had the pleasure of having her in front of this committee, but it's a great pleasure for me to have her backing me up here on the detailed questions.

I think the big point that needs to be recognized is that money market funds have proven themselves to be very, very safe investments, and it's done not in the form of making wild and crazy loans and investments and relying on a taxpayer backup. The only thing that they can invest in are highly liquid securities of the very highest quality, and they have very stringent diversification requirements. So, they are not allowed to put a very high percentage of their funds in any one security. We make them spread it out.

This gets into some complexities in how money funds are run, but we do allow in this one area cost accounting as an option for some funds under very stringent circumstances, and it ties into their ability effectively to price every day and be able instantly to liquidate shares for an investor. But, where institutions are relying on that, we require that they only, for example, invest in the highest grades of commercial paper. There are very stringent limitations on portfolio concentrations and so on.

The protection at base is the protection that the fund has invested solely in readily liquefiable money market instruments of the highest quality. The customer is relying on that and is, in essence, investing in a share of that portfolio. While it has not happened that a fund would fall below a dollar per share, it could happen. These funds do not have an explicit Government guarantee, and people should recognize that they are different from a deposit in a

bank. But they have an unblemished record for safety, and we spend a great deal of time and effort making sure that that continues to be that way.

The CHAIRMAN. Well, I appreciate the answer. This is a subject that ought to be talked about at somewhat greater length than we can give it at this particular time, but I appreciate your comments.

Let me thank you for your testimony today, and I want to say as well to the staff members that accompany you today and others who are not here that we appreciate very much the work that the SEC is doing and we look forward to continuing to work closely together.

Chairman BREEDEN. Thank you, Mr. Chairman.

The CHAIRMAN. The committee stands in recess.

[The committee recessed at 1:40 p.m., subject to the call of the Chair.]

[Response to written questions follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

WAYNE ANGELL

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

November 13, 1990

WAYNE D. ANGELL
MEMBER OF THE BOARD

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am responding to your letter of October 18 in which you asked for several statistical tabulations on national and state banks in connection with my testimony on September 10, 1990 before your Committee.

The data you requested are presented in the enclosures. Please let me know if I can be of any further assistance.

Sincerely,

Wayne

Enclosures

QUESTIONS FOR GOVERNOR ANGELL
FROM CHAIRMAN RIEGLE
SEPTEMBER 10, 1990

Q.1. Please provide a table with the following information for each year from 1984 through 1989 (as well as averages or totals for the six-year period):

(a) Assets of national banks as a percentage of the assets of all insured banks.

(b) Assets of national banks that failed during the year as a percentage of the assets of all insured banks that failed during the year.

(c) Assets of State member banks as a percentage of the assets of all insured banks.

(d) Assets of State member banks that failed during the year as a percentage of the assets of all insured banks that failed during the year.

(e) Assets of insured State nonmember banks as a percentage of the assets of all insured banks.

(f) Assets of insured State nonmember banks that failed during the year as a percentage of the assets of all insured banks that failed during the year.

(g) Number of national banks open at the beginning of the year.

(h) Number of national banks that failed during the year.

(i) Number of State member banks open at the beginning of the year.

(j) Number of State member banks that failed during the year.

(k) Number of insured State nonmember banks open at the beginning of the year.

(l) Number of insured State nonmember banks that failed during the year.

Chart 1

DATE	NUMBER OF FAILURES: NATIONAL	NUMBER OF FAILURES: NON MEMBER*	NUMBER OF FAILURES: STATE MEMBER	FAILED BANK ASSETS ($ Millions): NATIONAL	FAILED BANK ASSETS ($ Millions): NON MEMBER*	FAILED BANK ASSETS ($ Millions): STATE MEMBER	PERCENT OF TOTAL BANK ASSETS: NATIONAL	PERCENT OF TOTAL BANK ASSETS: NON MEMBER*	PERCENT OF TOTAL BANK ASSETS: STATE MEMBER	PERCENT OF TOTAL FAILED BANK ASSETS: NATIONAL	PERCENT OF TOTAL FAILED BANK ASSETS: NON MEMBER*	PERCENT OF TOTAL FAILED BANK ASSETS: STATE MEMBER
9/30/90	87	37	10	$7,293.5	$2,113.8	$193.9	59.3%	23.8%	16.9%	76.0%	22.0%	2.0%
1984 THROUGH 1989												
1989	110	80	14	22,553.3	4,923.0	548.0	59.9%	23.7%	16.4%	80.4%	17.6%	2.0%
1988	83	94	21	30,113.6	5,030.0	495.3	59.1%	23.8%	17.1%	84.5%	14.1%	1.4%
1987	60	112	10	1,838.0	4,086.6	416.1	59.1%	23.2%	17.7%	29.0%	64.4%	6.6%
1986	48	77	11	3,253.3	3,533.8	147.5	59.3%	22.5%	18.2%	46.9%	51.0%	2.1%
1985	30	75	11	1,255.6	1,397.1	193.1	59.8%	22.0%	18.2%	44.1%	49.1%	6.8%
1984	16	56	6	497.9	2,148.6	124.9	59.7%	22.1%	18.2%	17.7%	77.8%	4.5%
Total (1984 through 1989)	347	494	73	$59,501.7	$21,119.1	$1,924.9	--	--	--	--	--	--
Average (1984 through 1989	58	82	12	$9,917.0	$3,519.9	$320.8	59.5%	23.0%	17.5%	72.1%	25.6%	2.3%

Shaded area shows failed bank assets at September 30, 1990 as a percentage of total assets as of June 30, 1990.

* Excludes FDIC insured savings banks.

Source: FDIC and Federal Reserve

Chart 2

YEAR	NUMBER OF BANKS OPEN AT BEGINNING OF YEAR: NATIONAL	NON MEMBER*	STATE MEMBER	TOTAL	ASSETS OF BANKS OPEN AT BEGINNING OF YEAR: ($ MILLIONS) NATIONAL	NON MEMBER*	STATE MEMBER	TOTAL	NUMBER OF BANKS THAT FAILED EACH YEAR: NATIONAL	NON MEMBER*	STATE MEMBER	TOTAL
1990	4,179	7,500	1,034	12,713	$1,977,631	$780,480	$541,035	$3,299,146	87	37	10	134
1989	4,358	7,721	1,060	13,139	1,850,173	746,485	534,256	3,130,914	110	80	14	204
1988	4,629	8,001	1,097	13,727	1,773,432	697,008	529,563	3,000,003	83	94	21	198
1987	4,881	8,237	1,099	14,217	1,743,939	662,572	534,304	2,940,815	60	112	10	182
1986	4,959	8,386	1,072	14,417	1,632,559	602,415	495,696	2,730,670	48	77	11	136
1985	4,904	8,534	1,058	14,496	1,498,392	554,770	455,696	2,508,858	30	75	11	116
1984	4,751	8,648	1,051	14,450	1,393,406	513,654	426,228	2,333,288	16	56	6	78
Total	----	----	----	----	----	----	----	----	434	531	83	1,048

Shaded area represents failures through September 30, 1990.

* Excludes FDIC insured savings banks.

Source: FDIC and Federal Reserve

Chart 3

DATE	NUMBER OF FAILURES			FAILED BANK ASSETS ($ Millions)			PERCENT OF TOTAL BANK ASSETS			PERCENT OF TOTAL FAILED BANK ASSETS		
	NATIONAL	NON MEMBER*	STATE MEMBER	NATIONAL	NON MEMBER*	STATE MEMBER	NATIONAL	NON MEMBER*	STATE MEMBER	NATIONAL	NON MEMBER*	STATE MEMBER
9/30/90	87	43	10	$7,293.5	$6,153.8	$193.9	55.4%	28.8%	15.8%	53.5%	45.1%	1.4%
1984 THROUGH 1989												
1989	110	82	14	22,553.3	5,783.0	548.0	55.9%	28.8%	15.3%	78.1%	20.0%	1.9%
1988	83	96	21	30,113.6	5,080.0	495.3	54.9%	29.2%	15.9%	84.4%	14.2%	1.4%
1987	60	114	10	1,838.0	4,626.6	416.1	55.1%	28.4%	16.5%	26.7%	67.2%	6.1%
1986	48	79	11	3,253.3	3,573.8	147.5	55.8%	27.1%	17.1%	46.7%	51.2%	2.1%
1985	30	75	11	1,255.6	1,397.1	193.1	56.5%	26.3%	17.2%	44.1%	49.1%	6.8%
1984	16	56	6	487.9	2,148.6	124.9	56.7%	26.1%	17.2%	17.7%	77.8%	4.5%
Total (1984 through 1989)	347	545	73	$59,501.7	$22,609.1	$1,924.9	--	--	--	--	--	--
Average (1984 through 1989	58	84	12	$9,917.0	$3,768.2	$320.8	55.8%	27.8%	16.5%	70.8%	26.9%	2.3%

Shaded area shows failed bank assets at September 30, 1990 as a percentage of total assets as of June 30, 1990.

* Includes FDIC insured savings banks.

Source: FDIC and Federal Reserve

Chart 4

YEAR	NUMBER OF BANKS OPEN AT BEGINNING OF YEAR: NATIONAL	NON MEMBER*	STATE MEMBER	TOTAL	ASSETS OF BANKS OPEN AT BEGINNING OF YEAR: ($ MILLIONS) NATIONAL	NON MEMBER*	STATE MEMBER	TOTAL	NUMBER OF BANKS THAT FAILED EACH YEAR: NATIONAL	NON MEMBER*	STATE MEMBER	TOTAL
1990	4,179	7,969	1,034	13,182	$1,977,631	$1,020,947	$541,035	$3,539,613	87	43	10	140
1989	4,358	8,192	1,060	13,610	1,850,173	984,536	534,256	3,368,965	110	82	14	206
1988	4,629	8,464	1,097	14,190	1,773,432	914,133	529,563	3,217,128	83	96	21	200
1987	4,881	8,682	1,099	14,662	1,743,939	847,135	534,304	3,125,378	60	114	10	184
1986	4,959	8,750	1,072	14,781	1,632,559	759,807	495,696	2,888,062	48	79	11	138
1985	4,904	8,801	1,058	14,763	1,498,392	690,274	455,696	2,644,362	30	75	11	116
1984	4,751	8,942	1,051	14,744	1,393,406	684,372	426,228	2,504,006	16	56	6	78
Total	----	----	----	----	----	----	----	----	434	545	83	1,062

Shaded area represents failures through September 30, 1990.

* Includes FDIC insured savings banks.

Source: FDIC and Federal Reserve

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM

WAYNE ANGELL

Q.1. When a bank acquires deposits from the RTC or another bank, how does the acquiring bank account on its books for the purchase price or premium paid for the deposits?

A.1. Deposits are usually acquired through business combinations or through acquisitions of branches of financial institutions, both of which could result from RTC efforts. Under generally accepted accounting principles (GAAP) and Call Report requirements, when the deposits are acquired through a business combination accounted for as a purchase or through an acquisition of branches, the acquiring bank will record the fair value of the assets and deposits that have been purchased. If the purchase price exceeds the net fair value of these items (i.e., the fair value of the acquired assets less the fair value of the acquired deposits and other liabilities), intangible assets would be recorded. This may include goodwill and certain intangible assets representing the benefits that the acquiring bank expects to receive from lower funding costs of depositor relationships associated with the acquired deposits. Intangible assets must be amortized over their estimated useful lives under GAAP and for Call Report purposes (the estimated useful lives would generally not exceed 10 years for core deposit intangibles).

When the deposits are acquired through a business combination accounted for as a pooling of interests, the assets, deposits and other liabilities are recorded at their previous book values and no new intangibles are created.

Q.2. If value is paid for the core deposits, please explain to what extent that value is treated as an identifiable intangible asset for capital purposes?

A.2. When core deposit intangibles and related intangibles arise from the acquisition of deposits, these assets are considered identifiable intangibles under GAAP and our risk-based capital and leverage capital ratio guidelines. These assets are considered to be intangible assets by the accounting profession and are also treated as intangible assets for purposes of calculating tangible capital ratios.

Q.3. It was stressed that the amount of capital a bank has is one of the most important factors for the safety and soundness of the bank insurance fund. Do you believe that a cut in the capital gains rate would help banks to raise capital and raise the value of the assets held by the bank?

A.3. A capital gains tax preference likely would have the effects you suggest. It would tend to enlarge the supply of equity capital, thus lowering the cost of building core capital at banks; shareholders would be more inclined to forgo dividend returns, thus permitting greater retention of earnings, and new shares would be easier to sell. At the same time, banks' balance sheets could well benefit from a strengthened demand for assets, such as real estate, that either are held directly by the banks or that serve as collateral for loans. One potential offsetting factor may be noted, however: a cut in the tax on capital gains would make equity finance more attractive to nonbank corporations as well, which might translate into a reduced demand for bank loans and some other banking services.

On balance, and all other things equal (including other features of the tax code), I believe it reasonable to expect that a cut in the tax on capital gains would foster less reliance on highly leveraged financial structures in banking and in other sectors of the economy--clearly a desirable change, as recent events have demonstrated.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM

ROBERT CLARKE

Comptroller of the Currency
Administrator of National Banks

Q.1. When a bank acquires deposits from the RTC or another bank, how does the acquiring bank account on its books for the purchase price or premium paid for the deposits?

A.1. The premium paid for the deposits acquired from the RTC or another bank is generally recorded on the balance sheet of the acquiring bank as an intangible asset. Typically, this intangible asset is recorded as a core deposit intangible. The intangible asset is subsequently amortized as an expense over its estimated life. Generally, the amortization period ranges from 5 to 7 years, with a 10 year maximum allowed.

Q.2. If value is paid for the core deposits, please explain to what extent that value is treated as an identifiable intangible asset for capital purposes?

A.2. The risk-based capital guidelines (12 CFR Part 3) allow "qualifying intangibles" to be included as an asset for capital purposes. A qualifying intangible must satisfy three criteria: separability, marketability, and an identifiable cash flow.

Currently, a bank must demonstrate that any intangible asset other than mortgage servicing rights meets these criteria before it may be included as a qualifying intangible asset. To date, no bank has demonstrated that a core deposit intangible meet the three criteria.

However, the OCC is currently reexamining its position on the deduction of intangible assets from capital. As part of this reexamination, banks and other interested parties are being asked to comment on this policy. An Advance Notice of Proposed Rulemaking was issued to solicit these opinions. At this time it is not possible to determine what changes, if any, may result from this process.

Q.3. It was stressed that the amount of capital a bank has is one of the most important factors for the safety and soundness of the bank insurance fund. Do you believe that a cut in the capital gains rate would help banks to raise capital and raise the value of the assets held by the bank?

A.3. Over time, a cut in the capital gains tax rate could expand the market demand for assets subject to capital gains taxation. Common stocks, including bank stocks, could benefit. As a result, commercial banks could find it easier and less costly to raise capital through the issuance of new equity.

The extent of this benefit, however, would vary widely among issuers of bank stocks. Institutions with the highest likelihood of future appreciation in the value of their capital would benefit the most and firms with poor prospects for the future would benefit the least. In the current environment for bank stocks, it is doubtful that the market for new issues of bank equity would expand significantly.

It is also possible that a cut in the capital gains tax could affect the value of some assets held by banks, but the extent of any increase in value would seem to be limited. This is because most of the assets (i.e., loans, Treasury securities, state and local securities, etc.) held by a bank are treated, for income tax purposes, as ordinary assets.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

L. WILLIAM SEIDMAN

QUESTIONS FROM CHAIRMAN RIEGLE RESULTING
FROM CHAIRMAN SEIDMAN'S SEPTEMBER 10, 1990
TESTIMONY ON CAPITAL STANDARDS

Q.1 Please provide a table with the following information for each year from 1984 through 1989 (as well as averages or totals for the six-year period):

Q.1(a) Assets of national banks as a percentage of the assets of all insured banks.

A.1(a) This data may be found on Page 1 of the accompanying Chart at the line noted as Q.1(a).

Q.1(b) Assets of national banks that failed during the year as a percentage of the assets of all insured banks that failed during the year.

A.1(b) This data may be found on Page 1 of the accompanying Chart at the line noted as Q.1(b).

Q.1(c) Losses to the FDIC from national banks as a percentage of the losses to the FDIC (or, after FIRREA, the losses to the Bank Insurance Fund) from all insured banks.

A.1(c) This data may be found on Page 1 of the accompanying Chart at the line noted as Q.1(c).

Q.1(d) Assets of State member banks as a percentage of the assets of all insured banks.

A.1(d) This data may be found on Page 2 of the accompanying Chart at the line noted as Q.1(d).

Q.1(e) Assets of State member banks that failed during the year as a percentage of the assets of all insured banks that failed during the year.

A.1(e) This data may be found on Page 2 of the accompanying Chart at the line noted as Q.1(e).

Q.1(f) Losses to the FDIC from State Member banks as a percentage of the losses to the FDIC from all insured banks.

A.1(f) This data may be found on Page 2 of the accompanying Chart at the line noted as Q.1(f).

Q.1(g) Assets of insured State nonmember banks as a percentage of the assets of all insured banks.

Q.1(g) This data may be found on Page 3 of the accompanying Chart at the line noted as Q.1(g).

Q.1(h) Losses to the FDIC from insured State nonmember banks as a percentage of the losses to the FDIC from all insured banks.

Q.1(h) This data may be found on Page 3 of the accompanying Chart at the line noted as Q.1(h).

Q.1(i) Assets of insured State nonmember banks that failed during the year as a percentage of the assets of all insured banks that failed during the year.

Q.1(i) This data may be found on Page 3 of the accompanying Chart at the line noted as Q.1(i).

In addition, total number of bank failures and assistance transactions are found at the top of Page 1 of the accompanying Chart. Please refer to page 4 for additional information on assistance transactions. Total assets of all banks, total assets of failed banks, and estimated total losses of all failed banks also may be found at the top of Page 1. Total assets of all national banks, total assets of failed national banks, and estimated total losses of all failed national banks may be found at the middle of Page 1 of the accompanying Chart. Total assets of all state member banks, total assets of failed state member banks, and estimated total losses of all failed state member banks may be found at the top of Page 2 of the accompanying Chart. Finally, total assets of all state nonmember banks, total assets of failed state nonmember banks, and estimated losses of all failed state nonmember banks may be found at the top of Page 3 of the accompanying Chart.

The estimated loss figures for the year 1984 requested in Q.1(c), (f) and (h) are not readily available. However, this data could be complied and provided in one month, if necessary.

In addition, Tables 1 through 8 show these relationships in graphic form. Tables 9 and 9-a relate the total bank failures, by charter, from 1984 through September 1990. Tables 10 and 10-a show the number of failures and amount of total assets, by charter, for each year 1984 through 1989 and for the nine months ending September 1990. Table 12 shows estimated loss in failed banks, by charter, for the years 1985 through 1989.

(1.)

Analysis of Failed Banks by Charter
($ millions)

	1984	1985	1986	1987	1988	1989	1-1-90 to 6-30-90	1-1-90 to 9-30-90
Number of failures	78	120	145	203	277*	207	103	141
Total Banks	14,786	14,804	14,684	14,210	13,630	13,202	12,995	12,899
Total assets of failed banks	$2,864	$8,821	$7,687	$10,179	$53,821	$29,174	$9,348	$13,773
Total assets of all banks	$2,687,884	$2,916,011	$3,156,756	$3,255,988	$3,410,879	$3,579,036	$3,627,271	N/A
Total losses of all failed banks	N/A	$850	$1,833	$2,177	$5,661	$6,110	N/A	N/A
% of failures to total banks	0.5%	0.8%	1.0%	1.4%	2.0%	1.6%	0.8%	1.1%
% of total assets of failed banks to total assets of all banks	0.1%	0.3%	0.2%	0.3%	1.6%	0.8%	0.3%	N/A
Number of failures of national Banks	17	30	49	72	119	111	68	88
Total National Banks	4,904	4,959	4,881	4,629	4,358	4,179	4,066	N/A
Total assets of failed national banks	$523	$1,301	$3,777	$2,971	$42,324	$22,815	$4,801	$7,528
Total assets of all national banks	$1,498,392	$1,632,559	$1,743,939	$1,773,432	$1,850,173	$1,977,631	$1,992,840	N/A
Total losses of all failed national banks	N/A	$273	$713	$833	$4,195	$4,381		
% of failed national banks to all national banks	0.3%	0.6%	1.0%	1.6%	2.7%	2.7%	1.7%	N/A
% of total assets of failed national banks to total assets of all national banks	0.0%	0.1%	0.2%	0.2%	2.3%	1.2%	0.2%	N/A
% of failed national banks to all failed banks	21.8%	25.0%	33.8%	35.5%	43.0%	53.6%	66.0%	62.4%
Q.1. (a) % of total assets of national banks to total assets of all banks	55.75%	55.99%	55.24%	54.47%	54.24%	55.26%	54.94%	N/A
Q.1. (b) % of total assets of failed national banks to total assets of all failed banks	18.3%	14.7%	49.1%	29.2%	78.6%	78.2%	51.4%	54.7%
Q.1. (c) % of losses from national banks to losses from all failed banks	N/A	32.12%	38.90%	38.26%	74.10%	71.70%	N/A	N/A

N/A = Not Available

*Includes the 59 banks of First City Bancorporation which were handled through an open assistance transaction.

Analysis of Failed Banks by Charter
($ millions)

	1984	1985	1986	1987	1988	1989	1-1-90 to 6-30-90	1-1-90 to 9-30-90
Number of failures of SM banks	6	11	11	7	25	14	8	10
Total state member banks	1,058	1,072	1,099	1,097	1,060	1,034	1,020	
Total assets of failed SM banks	$130	$194	$143	$243	$1,835	$548	$171	$195
Total assets of all SM banks	$455,728	$495,696	$534,304	$529,563	$534,256	$541,035	$567,169	N/A
Total losses of all failed SM banks		$58	$37	$79	$131	$48		
% of failed state member banks to all state member banks	0.6%	1.0%	1.0%	0.6%	2.4%	1.4%	0.8%	N/A
% of total assets of failed state member banks to total assets of all state member banks	0.0%	0.0%	0.0%	0.0%	0.3%	0.1%	0.0%	N/A
% of failed state member banks to all failed banks	7.7%	9.2%	7.6%	3.4%	9.0%	6.8%	7.8%	7.1%
Q.1. (d) % of total assets of all SM banks to total assets of all banks	16.95%	17.00%	16.93%	16.26%	15.66%	15.12%	15.64%	N/A
Q.1. (e) % of total assets of failed SM banks to total assets of all failed banks	4.5%	2.2%	1.9%	2.4%	3.4%	1.9%	1.8%	1.4%
Q.1. (f) % of losses from SM banks to losses from all failed banks	N/A	6.82%	2.02%	3.63%	2.31%	0.79%	N/A	N/A

SM = State Member Bank

(3.)

Analysis of Failed Banks by Charter
($ millions)

	1984	1985	1986	1987	1988	1989	1-1-90 to 6-30-90	1-1-90 to 9-30-90
Number of failures of state NM banks	55	79	84	123	133	82	25	41
Total state nonmember banks	8,534	8,386	8,237	8,001	7,721	7,500	7,430	N/A
Total assets of failed state NM banks	$2,211	$7,325	$3,736	$6,435	$9,661	$5,811	$1,676	$3,350
Total assets of all state NM banks	$690,274	$759,807	$847,135	$914,133	$984,536	$1,020,947	$1,033,529	N/A
Total Losses of all failed NM banks	N/A	$519	$1,083	$1,266	$1,335	$1,682	N/A	N/A
% of failed state nonmember banks to all state nonmember banks	0.6%	0.9%	1.0%	1.5%	1.7%	1.1%	0.3%	N/A
% of total assets of failed state nonmember banks to total assets of all state nonmember banks	0.3%	1.0%	0.4%	0.7%	1.0%	0.6%	0.2%	N/A
% of failed state nonmember banks to all failed banks	70.5%	65.8%	57.9%	60.6%	48.0%	39.6%	24.3%	29.1%
Q.1. (g) % of total assets of all nonmember banks to total assets of all banks	25.68%	26.06%	26.84%	28.08%	28.86%	28.53%	28.49%	N/A
Q.1. (i) % of total assets of failed state nonmember banks to total assets of all failed banks	77.2%	83.0%	48.6%	63.2%	18.0%	19.9%	17.9%	24.3%
Q.1. (h) % of losses from NM banks to losses from all failed banks	N/A	61.06%	59.08%	58.15%	23.58%	27.53%	N/A	N/A
Total Assets of (BIF-Insured) FSBs	$43,490	$27,949	$31,378	$38,860	$41,914	$39,423	$33,733	N/A
Number of failures of (BIF-Insured) FSBs	0	0	1	1	0	0	2	2
Total Assets of failed (BIF-insured) FSBs			$32	$530			$2,700	$2,700
% of failed FSBs to all failed banks			0.69%	0.49%			1.94%	1.42%
% of total assets of failed FSBs to total assets of all failed banks			0.42%	5.21%			28.88%	19.60%

NM = Non Member
FSB = Federal Savings Bank

Notes

1. Total assets of failed banks came from bid packages prepared prior to the banks' failure.

2. Total assets and number of banks was taken from yearend Call Report Data.

3. Includes Open-bank Assistance transactions:

	Number	Total Assets	Number	Nationals	Number	NM	Number	SM
1984	1	$513			1	$513		
1985 *	4	$5,889			4	$5,889		
1986	7	$721	1	$468	6	$253		
1987 **	19	$2,551	9	$1,104	9	$1,447		
1988 ***	77	$13,462	38	$7,926	35	$4,264	4	$1,273
1989	1	$6	1	$6				
1990	1	$16	1	$16				

* Includes The Bowery Savings Bank at $5,277,000,000.
** Includes Syracuse Savings Bank at $1,236,000,000, and 11 banks in the BancTexas system at $1,193,000,000.
*** Includes the 59 banks of First City Bancorporation at $11,201,000,000.

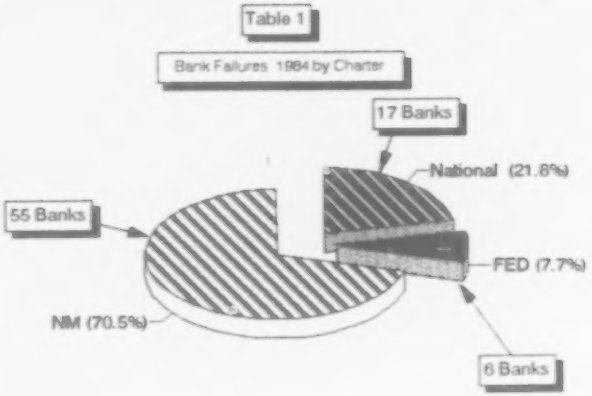


Table 1
Bank Failures 1984 by Charter
17 Banks
National (21.8%)
55 Banks
FED (7.7%)
NM (70.5%)
6 Banks

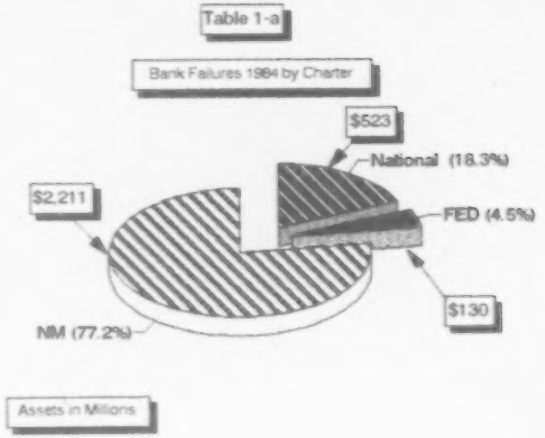


Table 1-a
Bank Failures 1984 by Charter
$523
National (18.3%)
$2,211
FED (4.5%)
$130
NM (77.2%)
Assets in Millions

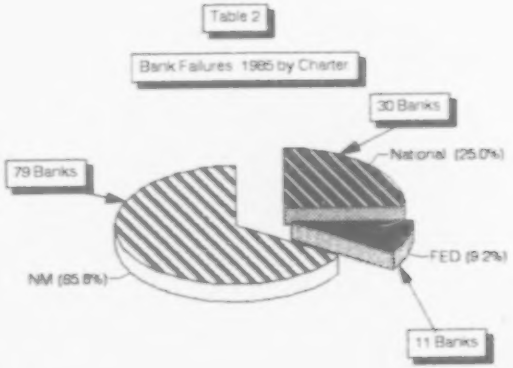


Table 2
Bank Failures 1985 by Charter
30 Banks
National (25.0%)
79 Banks
FED (9.2%)
NM (65.8%)
11 Banks

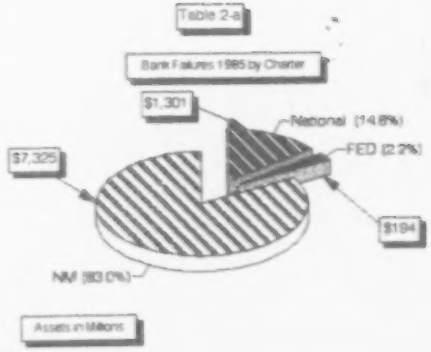


Table 2-a
Bank Failures 1985 by Charter
$1,301
National (14.8%)
FED (2.2%)
$7,325
$194
NM (83.0%)
Assets in Millions

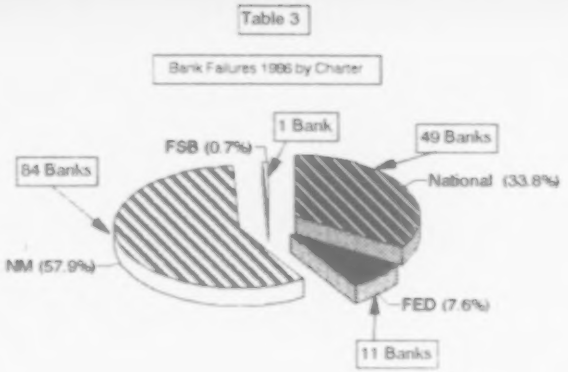


Table 3
Bank Failures 1986 by Charter
1 Bank
49 Banks
FSB (0.7%)
National (33.8%)
84 Banks
NM (57.9%)
FED (7.6%)
11 Banks

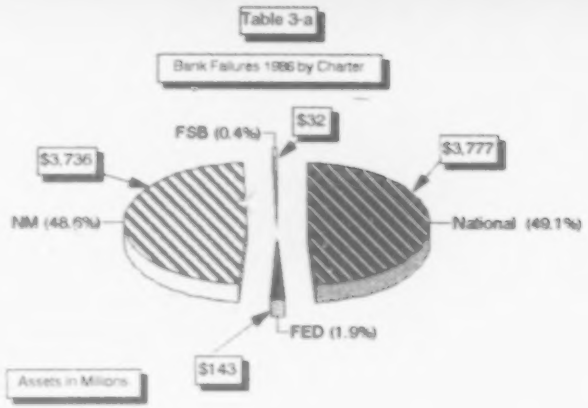


Table 3-a
Bank Failures 1986 by Charter
FSB (0.4%)
$32
$3,777
$3,736
National (49.1%)
NM (48.6%)
FED (1.9%)
$143
Assets in Millions

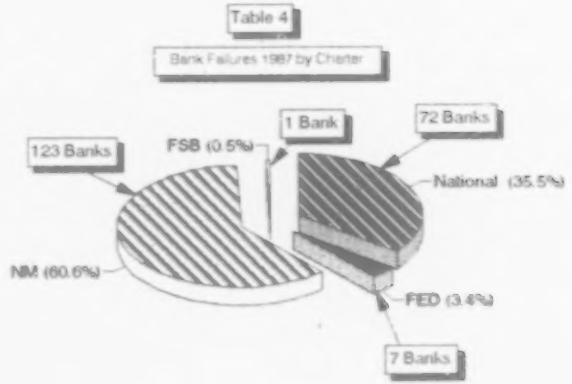


Table 4
Bank Failures 1987 by Charter
1 Bank
72 Banks
123 Banks
FSB (0.5%)
National (35.5%)
NM (60.6%)
FED (3.4%)
7 Banks

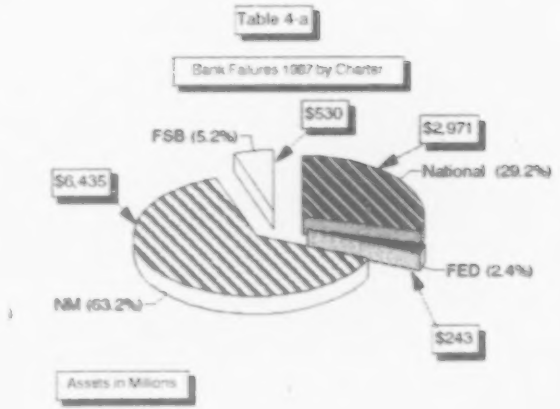


Table 4-a
Bank Failures 1987 by Charter
$530
FSB (5.2%)
$2,971
National (29.2%)
$6,435
FED (2.4%)
NM (63.2%)
$243
Assets in Millions

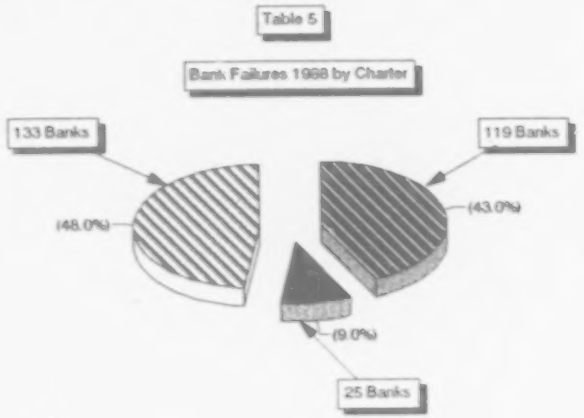


Table 5
Bank Failures 1988 by Charter
133 Banks
(48.0%)
119 Banks
(43.0%)
(9.0%)
25 Banks

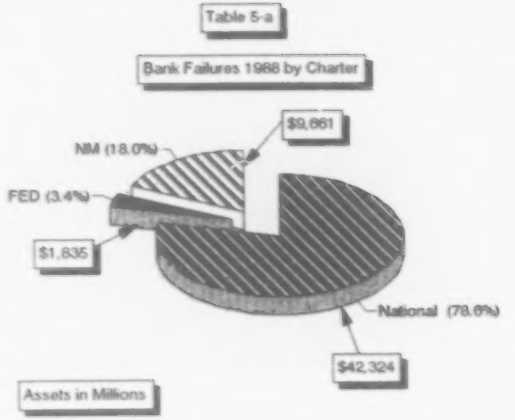


Table 5-a
Bank Failures 1988 by Charter
$9,661
NM (18.0%)
FED (3.4%)
$1,835
National (78.6%)
$42,324
Assets in Millions

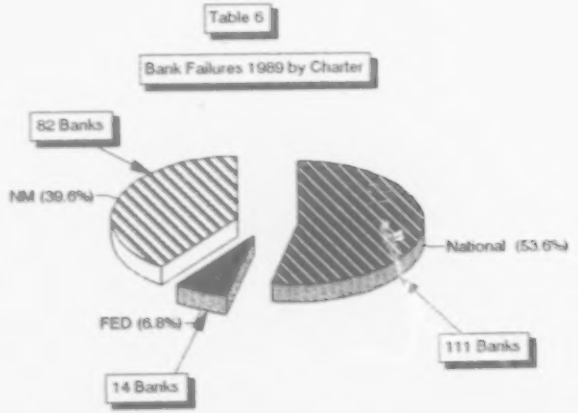


Table 6
Bank Failures 1989 by Charter
82 Banks
NM (39.6%)
National (53.6%)
FED (6.8%)
111 Banks
14 Banks

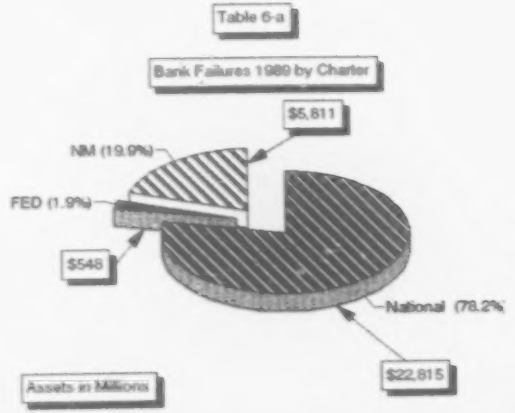


Table 6-a
Bank Failures 1989 by Charter
$5,611
NM (19.9%)
FED (1.9%)
$548
National (78.2%)
$22,815
Assets in Millions

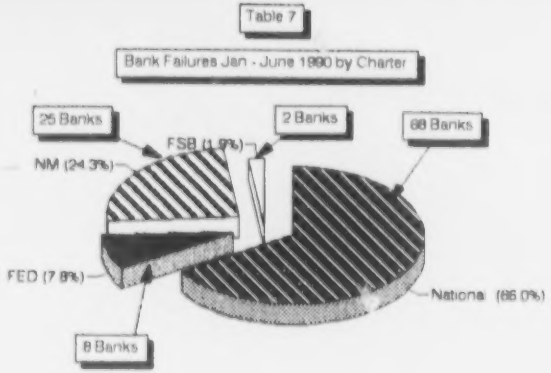


Table 7
Bank Failures Jan - June 1990 by Charter
25 Banks
NM (24.3%)
FSB (1.9%)
2 Banks
88 Banks
FED (7.8%)
National (65.0%)
8 Banks

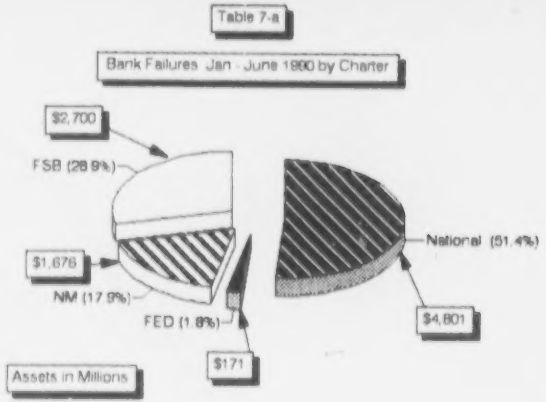


Table 7-a
Bank Failures Jan - June 1990 by Charter
$2,700
FSB (28.9%)
National (51.4%)
$1,676
NM (17.9%)
$4,801
FED (1.8%)
$171
Assets in Millions

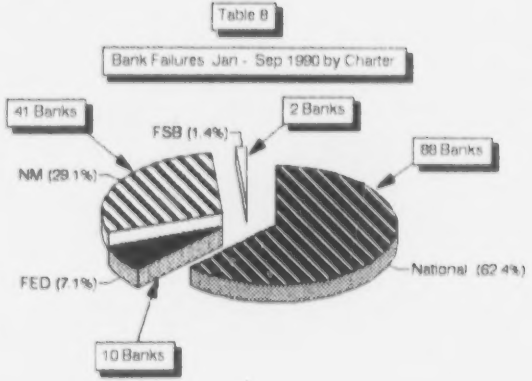


Table 8
Bank Failures Jan - Sep 1990 by Charter
41 Banks
FSB (1.4%)
2 Banks
88 Banks
NM (29.1%)
National (62.4%)
FED (7.1%)
10 Banks

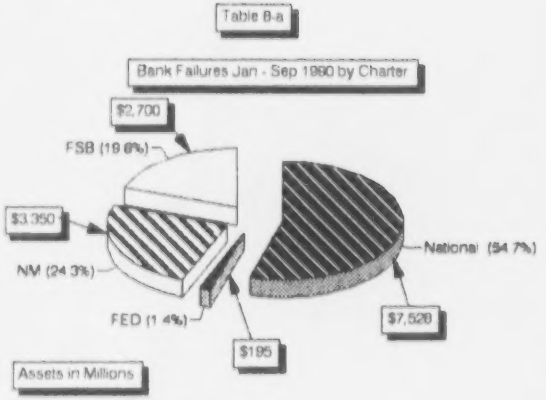


Table 8-a
Bank Failures Jan - Sep 1990 by Charter
$2,700
FSB (19.6%)
$3,350
National (54.7%)
NM (24.3%)
$7,528
FED (1.4%)
$195
Assets in Millions

Table 9

Bank Failures 1984 - Sep 1990 by Charter

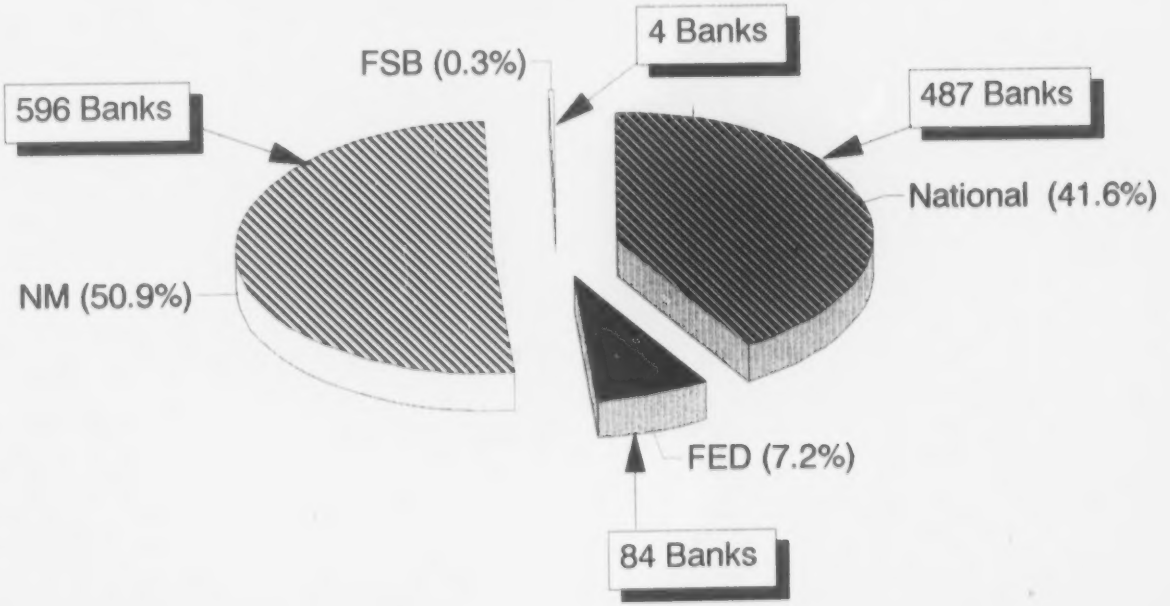
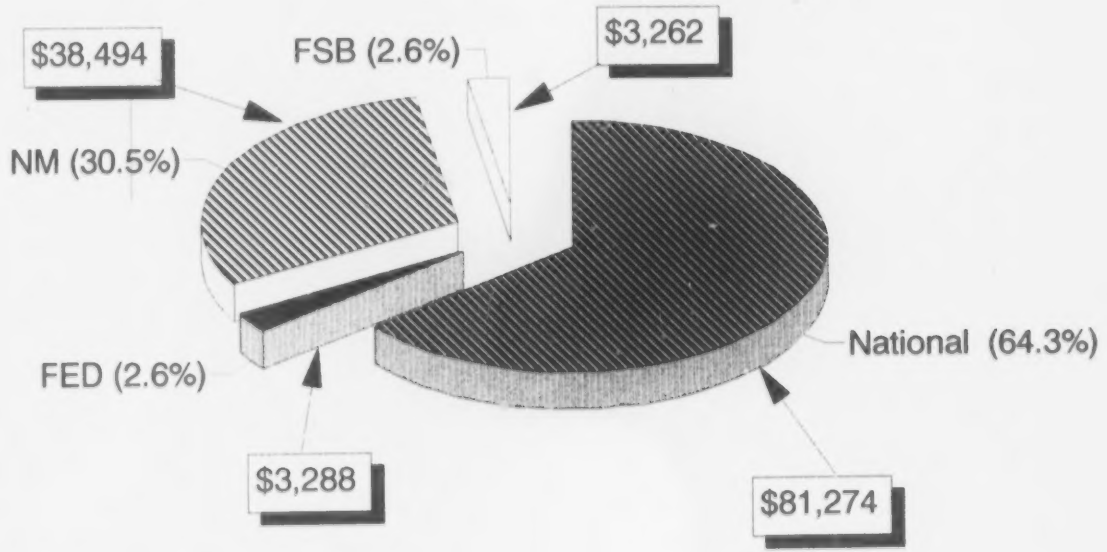


Table 9-a

Bank Failures 1984 - Sep 1990 by Charter



In Millions

Table 10

Number of Failed Banks by Charter

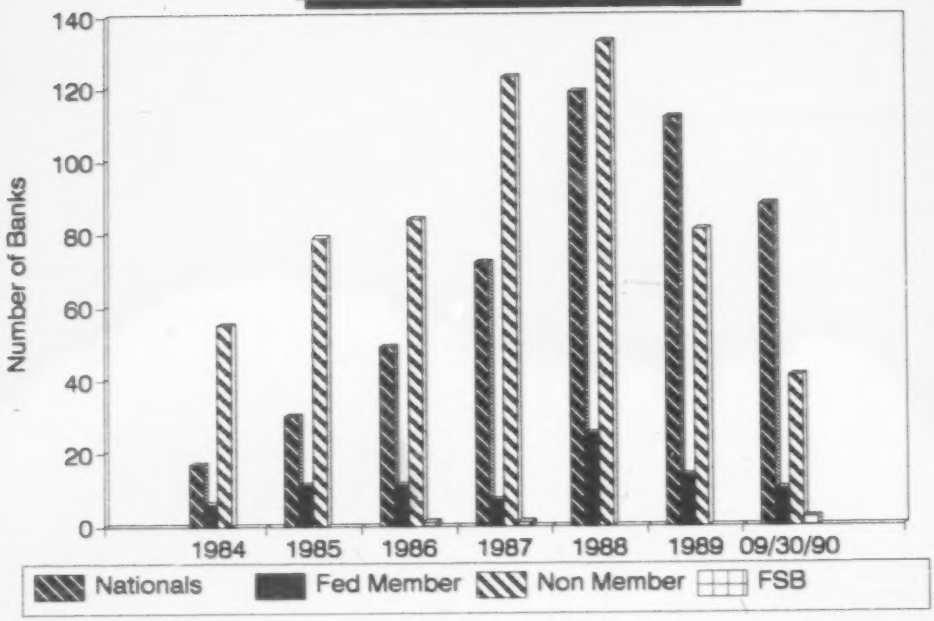


Table 10-a

Assets of Failed Banks by Charter

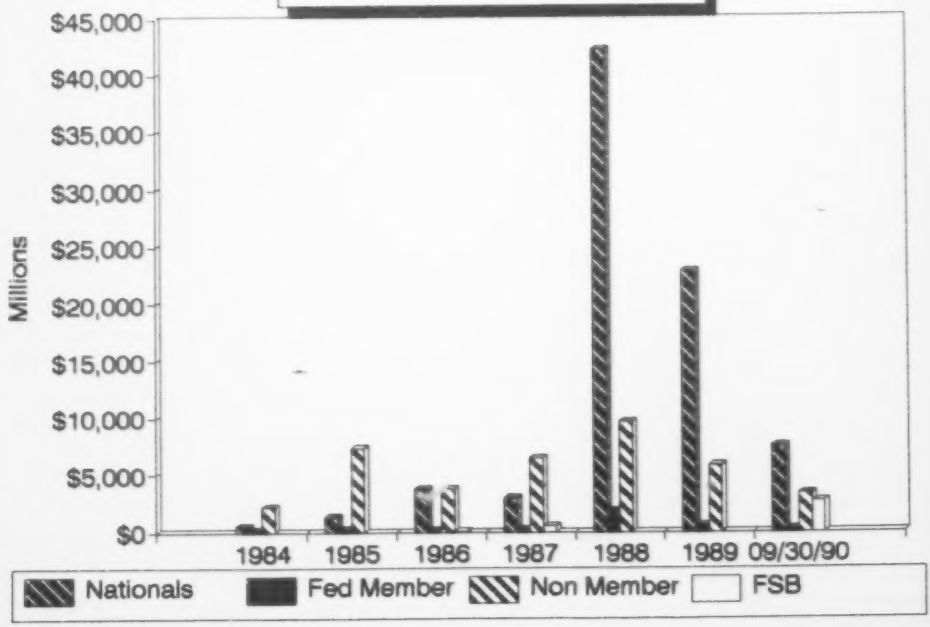
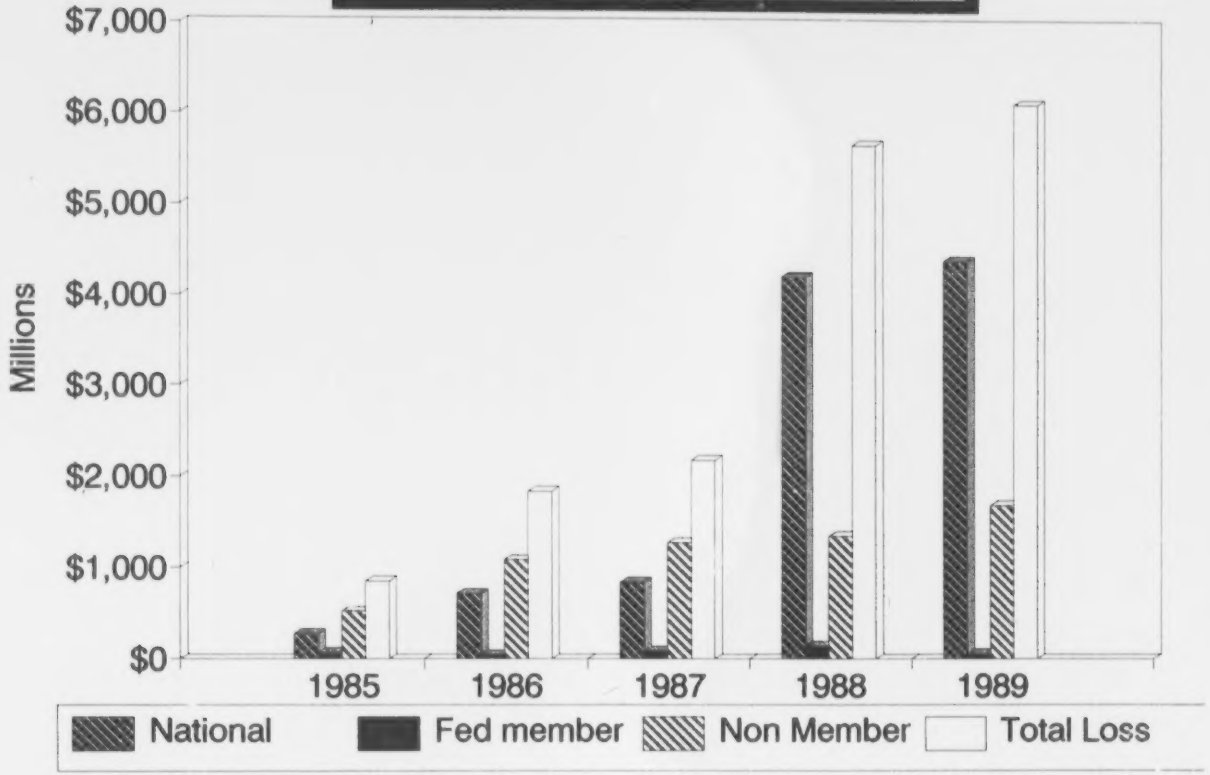
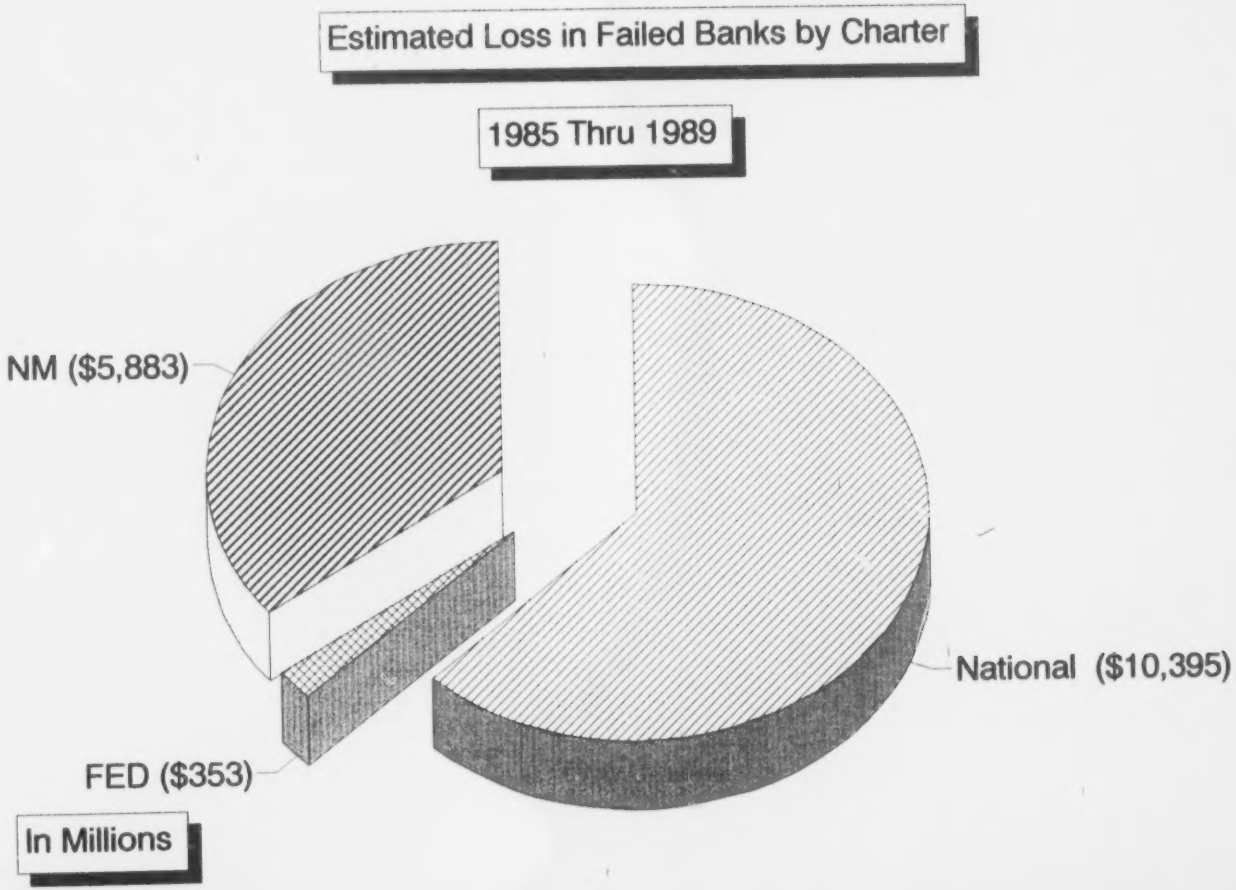


Table 12

Estimated Loss in Failed Banks by Charter




Estimated Loss in Failed Banks by Charter
1985 Thru 1989
NM ($5,883)
National ($10,395)
FED ($353)
In Millions

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM

L. WILLIAM SEIDMAN

Q.1. When a bank acquires deposits from the RTC or another bank, how does the acquiring bank account on its books for the purchase price or premium paid for the deposits?

A.1. The accounting for an acquisition by a bank or other corporation is governed by the provisions of Accounting Principles Board Opinion No. 16, "Business Combinations." Paragraph 87 of that opinion states that:

> An acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed....
>
> First, all identifiable assets acquired, either individually or by type, and liabilities assumed in the business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.
>
> Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill.

Paragraph 4 of Financial Accounting Standards Board Statement No. 72, "Accounting for Certain Acquisitions of Banking or Thrift Institutions," provides specific guidance for financial institutions and states:

> ... [I]ntangible assets acquired that can be separately identified shall be assigned a portion of the total cost of the acquired enterprise if the fair values of those assets can be reliably determined. The fair values of such assets that relate to depositor or borrower relationships shall be based on the estimated benefits attributable to the relationships that exist at the date of acquisition without regard to new depositors or borrowers that may replace them. Those identified intangible assets shall be amortized over the estimated lives of those existing relationships.

Any excess of the cost of the acquisition over the fair value of the tangible and identifiable intangible assets acquired less liabilities assumed is an unidentifiable intangible asset, goodwill. Intangible assets, both identifiable (e.g., core deposit intangible) and unidentifiable (i.e., goodwill), are reportable in a separate asset category on a bank's Statement of Condition (balance sheet). In accordance with regulatory instructions, intangible assets should be amortized over their estimated useful lives, not to exceed 15 years, except in those cases where a shorter amortization period has been prescribed by the bank's primary federal bank supervisory authority.

Q.2. If value is paid for the core deposits, please explain to what extent that value is treated as an identifiable intangible asset for capital purposes?

A.2. For capital purposes, the same treatment applies whether the premium paid in an acquisition of deposits is assigned to the identifiable intangible asset, core deposit intangible, or to goodwill. Under our current capital standards adopted as Part 325 of the FDIC Rules and Regulations (12 C.F.R. 325) in 1985, the definition of primary capital includes common stockholders' equity (i.e., common stock, capital surplus, and undivided profits), as well as perpetual preferred stock, minority interests in consolidated subsidiaries, the allowance for loan and lease losses, and limited amounts of mandatory convertible debt minus intangible assets other than mortgage servicing rights and assets classified loss. The risk-based capital rules adopted by the FDIC in 1989 (12 C.F.R. 325, Appendix A), effective December 31, 1990, define core (Tier 1) capital as common stockholders' equity, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries less all intangible assets other than mortgage servicing rights. Furthermore, the FDIC's recently proposed amendment to Part 325 (55 Federal Register 39288) revising the minimum required leverage capital ratio uses the same capital definitions as the risk-based capital framework.

Nevertheless, the risk-based capital rules do provide an exception from the capital deduction treatment for intangibles other than mortgage servicing rights if those other intangibles are explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. In evaluating whether other types of intangibles should be recognized for regulatory capital purposes on a specific case basis, the FDIC will accord special attention to the general characteristics of the intangibles, including: (1) the separability of the intangible asset and the ability to sell it separate and apart from the bank or the bulk of the bank's assets; (2) the certainty that a readily identifiable stream of cash flows

associated with the intangible asset can hold its value notwithstanding the future prospects of the bank; and (3) the existence of a market of sufficient depth to provide liquidity for the intangible asset. Since a core deposit intangible asset does not satisfy all three criteria, it is not likely that it will be considered for inclusion in the FDIC's capital calculations.

Q.3. It was stressed that the amount of capital a bank has is one of the most important factors for the safety and soundness of the bank insurance fund. Do you believe that a cut in the capital gains rate would help banks to raise capital and raise the value of the assets held by the bank?

A.3. Although a cut in the capital gains rate may be of some nominal help to banks in raising capital, the FDIC believes that a restructuring of the banking industry will make it more attractive for investors to provide the much needed capital. Banking organizations should be free to offer a wide range of products and services, with the major caveat being that many of the products and services should be in uninsured subsidiaries or affiliates of a bank rather than in the bank itself. In addition, the FDIC can discern no valid reason to limit the type of entities that can own or be affiliated with banks. Furthermore, despite the actions of states allowing, in various forms, interstate expansion by bank holding companies, the free market ideal of no geographic restraints on the banking business has still not been achieved. The diversity of state laws imposes substantial restrictions on bank holding company expansion. All of these restrictions tend to make banking organizations less attractive to the investor seeking to earn an adequate return on capital.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM

T. TIMOTHY RYAN

Q.1. When a bank acquires deposits from the RTC or another bank, how does the acquiring bank account on its books for the purchase price or premium paid for the deposits?

A.1. When a financial institution acquires deposits from the RTC or another bank at a premium, the acquiring bank should account for the premium as an intangible asset.

According to generally accepted accounting principles (GAAP), "the purchase price paid for a [banking or thrift institution] may include an amount for one or more factors, such as:

a. Capacity of existing savings accounts and loan accounts to generate future income.
b. Capacity of existing savings accounts and loan accounts to generate additional business or new business.
c. Nature of territory served."

The first two factors discussed above, when considered in circumstances where deposits are acquired, are generally referred to as "core deposit intangibles." Most RTC resolutions that have been consummated to date have involved core deposit intangibles.

GAAP requires that the value that relates to core deposits be based on the estimated benefits attributable to the relationships that existed at the date of acquisition without regard to new depositors that may replace them. The portion of the premium paid that relates to the value of the core deposits is treated as an "identifiable intangible asset," and is amortized over the estimated life of the core deposits.

The third factor listed above represents an unidentifiable asset, or goodwill.

For example, assume that an institution assumes $100 million in deposits from the RTC, and receives a $98 million cash payment from RTC and the $2 million difference is attributable to core deposits. In this case, a $100 million liability would be recorded

Q.2. If value is paid for the core deposits, please explain to what extent that value is treated as an identifiable intangible asset for capital purposes?

A.2. If identifiable value is paid for the value of core deposits and an asset called "core deposit intangibles" is created under GAAP, the value is treated as an identifiable intangible asset for capital purposes.

Under the capital regulations, all intangible assets (except for qualifying supervisory goodwill, which is granted special treatment under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 [FIRREA]) must pass a 3-part test before they can be included in the asset base of institutions when calculating core capital. The 3-part test requires that:

(i) The intangible asset must be able to be separated and sold apart from the savings association or from the bulk of the savings association's assets;

(ii) The market value of the intangible asset must be established on an annual basis through an identifiable stream of cash flows, and there must be a high degree of certainty that the asset will hold this market value notwithstanding the future prospects of the savings association; and

(iii) The savings association must demonstrate and document that a market exists which will provide liquidity for the intangible asset.

If the intangible asset passes that 3-part test, it is included in assets when calculating core capital, though it is limited to an amount equal to 25% of core capital (except if it is purchased mortgage servicing rights, which are granted special treatment under FIRREA).

The Office of Thrift Supervision (OTS) has issued guidance to the thrift industry that states that until OTS provides final guidance, and when management of an institution concludes that core deposit intangibles recorded at the time of a purchase transaction are qualifying intangible assets (under the above 3-part test), they may include it in the calculation of core capital.

OTS continues to work with the bank regulatory agencies to develop final, consistent inter-agency guidance on the question of whether core deposit intangibles should be included in the calculation of capital.

Q.3. It was stressed that the amount of capital a bank has is one of the most important factors for the safety and soundness of the bank insurance fund. Do you believe that a cut in the capital gains rate would help banks to raise capital and raise the value of the assets held by the bank?

A.3. While it is difficult to determine the magnitude of the positive effect, a cut in the capital gains rate would help all stockowned enterprises, including banks and thrifts, to raise capital. By increasing the after-tax rate of return provided by equities relative to other investments, a cut in the capital gains tax would serve to reallocate available investment dollars to equity securities. A cut in the capital gains tax, moreover, would create an incentive for banks and thrifts to retain their profits--thereby increasing their capital--rather than pay profits out as dividends, assuming that the bank or thrift could earn a competitive return on the retained capital. Stockholders would prefer that banks and thrifts retain profits because the increase in stock prices that would result from retaining profits would be taxed favorably relative to dividend payments.

In addition, a cut in the capital gains tax would increase investor demand for many of the assets held by banks and thrifts, for example, real estate assets, as investors sought the greater effective appreciation afforded by these assets. Therefore, a cut in the capital gains tax would also increase the value of bank and thrift assets.